Analytical Review of Bangladesh's Macroeconomic Performance in Fiscal Year 2011-12

(Second Reading)

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Content

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The CPD IRBD 2011-12 Team alone remains responsible for the analyses and interpretations presented in this report.

1. INTRODUCTION

The present document, prepared under the Centre for Policy Dialogue's (CPD) flagship programme *Independent Review of Bangladesh's Development (IRBD)*, contains the second reading on the state of the Bangladesh economy for the fiscal year 2011-12 (FY2012). It may be recalled that the first interim report on the performance of the economy during the current fiscal year was released by CPD on 3 November 2011.

In view of a number of tensions those were becoming evident in the economy since the second half of FY2011, in its pre-budget analysis of the state of economy, CPD identified four sets of risks that loomed in the horizon. These risks related to: (i) financing of public expenditures; (ii) macroeconomic balances; (iii) capacity of the development administration; and (iv) political scenario (CPD 2011b). The first interim report on FY2012 further validated the existence of these risks, and observed that the economy, during the initial months (July – September) of the current fiscal year has come under a complex set of stresses and strains emanating from multiple sources. CPD's analysis concluded that keeping Bangladesh economy on a sustainable and inclusive growth trajectory as well as maintaining and consolidating macroeconomic balances will be a very challenging task in FY2012. It was further observed that FY2012 will be, on many counts, one of the relatively difficult years in the recent past from the perspective of macroeconomic management (CPD 2012).

CPD's second reading of the economic trends in FY2012 builds on the benchmarks provided in its earlier reports, and particularly seeks to trace the major changes in the macroeconomic scenario since November 2011. In this connection, the present review takes stock of the performance of the national economy in certain key areas covering the first six months (July – December 2011) of FY2012. The review sets the stage by analysing the most recent trends in the global and regional economies and tries to interpret their implications for Bangladesh. The focus areas of the review include the state of public finance, monetary sector, capital market and balance of payments (BOP) situation. The document rounds off with an analysis of the short-term outlook of the economy including its growth prospect.

The analyses and interpretations offered in this document draws on the accumulated knowledge base of the CPD-IRBD. Furthermore, specific sections of the report are based on detailed theme papers prepared for the volume. Most recent data available from the concerned official sources have been analysed to prepare the theme papers. Additional information on certain issues has been included as Annex to the report.

It may be mentioned that this second interim report will be followed up by a state of the economy report covering the full fiscal prior to the announcement of the annual budget for FY2013. CPD, in between, will also prepare a set of recommendations for inclusion in the upcoming national budget.

2. AN UNCERTAIN GLOBAL ECONOMIC OUTLOOK

Multiple downside risks and growing uncertainties continued to characterise the global economy as it entered into 2012. Double-dip depression was not unlikely, particularly in the backdrop of a slowing pace of economic growth in the last quarter of 2011, and weak growth projections for 2012 and 2013. Persistently high unemployment rate, low consumer and business confidence, and volatility in financial sectors are likely to have wide ranging implications for the economies of the European Union (EU) and the United States of America (USA), two major markets of products exported by developing countries. Added to this, some of the policy measures pursued by these economies could further dampen domestic demand of these countries, at least in the short-run.[1] For economies such as Bangladesh, with their increasing degree of openness and growing global integration, the evolving global economic scenario calls for a close examination of the likely impact in terms of all dimensions of their global integration.

2.1 Faltering Recovery in Developed Economies

As the global economy embarked on 2012 with the apprehension of a double-dip depression, new estimates indicate that global output is expected to expand by 2.6 and 3.2 per cent in 2012 and 2013 respectively (Table 2.1), and the gross domestic product (GDP) growth in the advanced economies is expected to increase by 1.3 per cent which is similar to that in 2011. The US economy in 2012 was expected to grow at somewhat slower pace than in 2011, though the employment situation is improving very slowly. Meanwhile, if US economy's immediate future looks discouraging, that of the EU appears to be outright bleak in view of the fiscal austerity programmes in force across Europe, coupled with the ongoing sovereign debt crisis. Italy and the Netherlands are the latest addition to Greece, Portugal and Belgium, which are already being pushed into recession. However, bigger economies of the region, including France and Germany, so far have managed to stay afloat by clutching on to the edge of the crisis. Hence, it is plausible that the Eurozone has been able to marginally avoid recession for now. However, measures which have been either initiated or underway to tackle the crisis, are yet to raise business and market confidence and have indeed failed to reduce the longer-term borrowing costs of these countries.

Table 2.1: Growth of World Output: 2005-2012

(Annual Percentage Change)

Region	2005-2008 (Average)	2009	2010	2011	2012[2]	2012[3]	Difference
World	3.3	-2.1	3.9	2.8	3.6	2.6	-1.0
USA	1.9	-2.6	2.9	1.7	2.8	1.5	-1.3
European Union	2.2	-4.2	1.8	1.6	1.8	0.7	-1.1
South Asia	7.5	5.7	7.1	6.5	7	6.7	-0.3
China	11.3	9.1	10.3	9.3	8.9	8.7	-0.2
LDCs	7.7	4.1	5.6	4.9	5.9	5.7	-0.2

Source: UNDESA (2012).

[1]As it stands, the present macroeconomic policies pursued by the majority of the developed economies are characterised by a combination of loose monetary policy stance and fiscal austerity. Martin Feldstein, Professor of Economics at the Harvard University apprehended that removal of 'cyclical' budget deficits by raising taxes and reducing expenditure would reduce aggregate demand even more (Feldstein 2012). Nobel Laureate economist Professor Joseph E Stiglitz also cautioned that the ongoing austerity measures may only exacerbate the economic slowdown in developed countries. He believes that even in the absence of an expansionary fiscal policy, a 'balanced budget' approach by increasing both taxes and expenditure may help create employment and increase output (Stiglitz 2012).

[2]As of September 2011.

[3]As of January 2012.

2.2 Uncertainty Looming over Some Developing Economies

Growth in developing countries has also been revised downward since the last forecast in June by the UN.[4] Brazil's growth has already stalled, fuelling anxiety among her neighbours in Latin America. The economic performance of India and China may be able to demonstrate relatively strong growth in 2012, thanks to their strong domestic demand. Recovery of Libya and the performance of oil exporting countries may accelerate the economic activities of Middle East and North African countries. As a group, the least developed countries (LDCs) may turn out to be an exception, as their growth momentum is expected to continue despite the weakening global environment.

2.3 Inevitable Slowdown of International Trade and Remittance Inflow

The upturn in the expansion of global trade in 2010 has been estimated to slowdown in 2011 (Table 2.2).[5] In contrast to the deteriorating terms of trade of economies dependent on manufactured exports, terms of trade of economies dependent on mineral and oil export will continue to rebound off the export price collapse in 2009. From projections for 2012, it appears that with growing South-South trade, emerging economies would continue to attain higher growth rates in terms of trade volume, and trade prospects for LDCs will perhaps hinge on the level of their integration with the emerging economies. With the Doha Development Round negotiation of the World Trade Organization (WTO) being in a deadlock, some are apprehensive that a new wave of protectionism could show up in view of the emerging depressed global outlook, with consequent adverse impact on exports from developing countries.

Table 2.2: Outlook for International Trade

Source	2010	2011	2012[6]	2012[7]	Difference	2013 (P)
World Bank	12.4	6.6	7.7	4.7	-3.0	6.8
UNDESA	12.6	6.6	6.8	4.4	-2.4	5.7
IMF	12.7	6.9	5.8	3.8	-2.0	5.4
Advanced (Import)	*11.5*	*4.8*	*4.0*	*2.0*	*-2.0*	*3.9*
Emerging (Import)	*15.0*	*11.3*	*8.1*	*7.1*	*-1.0*	*7.7*
Advanced (Export)	*12.2*	*5.5*	*5.2*	*2.4*	*-2.8*	*4.7*
Emerging (Export)	*13.8*	*9.0*	*7.8*	*6.1*	*-1.7*	*7.0*

Source: World Economic Prospect – January 2012, World Bank; World Economic Outlook – January 2012, IMF; World Economic Situation and Prospects – January 2012, UNDESA.

Following a turnabout in 2011, remittance flows to developing countries are expected to grow by 7.3 per cent in 2012 (World Bank 2011). However, the forecasted growth rate is considerably lower than the 2003-08 period when the annual increase in remittances to developing countries averaged 20 per cent.[8]

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[4]In 2012, developing economies are expected to grow by 5.6 per cent (0.6 percentage point less than the earlier forecast).
[5]Growth in merchandise trade would come down to 6.6 per cent in 2011, and is expected to continue at a slower pace of 4.4 per cent in 2012 and 5.7 per cent in 2013 (UNDESA 2012). World Bank and the International Monetary Fund (IMF) have also projected similar trends.
[6]As of September 2011.
[7]As of January 2012.
[8]Officially recorded remittance flows to developing countries are estimated to have reached USD 351 billion in 2011, 8 per cent increase over 2010.

2.4 Persisting High Level of Commodity Prices

After two years of strong growth, international commodity prices have become more or less stabilised in 2011. In view of the improved supply prospects and sluggish growth in demand in 2012, it is envisaged that commodity prices will decline, but price levels may remain high for many important commodities including oil, foodgrains and fertiliser. The growing inflationary pressure in developed economies in 2011 may be somewhat moderated with weakening of aggregate demand and subdued wage pressure of continued unemployment. In contrast, inflation in developing countries, though is expected to decelerate, will continue to be a major policy concern. With the forecast of sustained high inflation, governments in South Asian countries may have to continue, if not increase, their support to social welfare and safety net programmes.

2.5 Strong FDI Inflow to Developing Countries Anticipated

Global foreign direct investment (FDI) is expected to bounce back to its pre-crisis level in 2011, with a flow of about USD 1.4-1.6 trillion, and could reach its earlier peak[9] in 2013 (UNCTAD 2011). Developing economies have emerged as the highest absorbers of global FDI, and these countries are likely to continue attracting more FDI in the near future.

2.6 Additional ODA Flow Unlikely

Official development assistance (ODA) is expected to shrink due to greater fiscal austerity and sovereign debt problems in developed countries. A survey by the OECD reported that the disbursement of bilateral aid from the Development Assistance Committee (DAC) members to developing countries will be at a sluggish annual growth of only 1.3 per cent in 2011 to 2013. Delinking aid flows from business cycles of advanced economies, apart from delivering on existing aid commitments, may determine the development outcome and attainment of the Millennium Development Goals (MDGs) in many LDCs.

2.7 Challenges Awaiting for Bangladesh

The aforementioned uncertainties and volatilities in the global economy are likely to have important implications for the increasingly globalised economy of Bangladesh. As may be recalled, during the last global economic crisis, a number of developing economies including Bangladesh were impacted significantly through various transmission channels including trade, remittances, foreign aid and financial flows (ODI 2010).Estimates carried out at CPD indicate that GDP shrank by about 0.59 per cent because of the crisis (Box 2.1).

[9]In 2007, global FDI was recorded to be the highest with a flow of USD 1.9 trillion.

Box 2.1: Impact of Global Financial and Economic Crisis on Bangladesh

The global financial and economic crisis of 2007-2008, although belatedly, impacted the economy of Bangladesh through various channels. These effects are expected to have a spillover effect on the GDP growth rate in the coming years. In order to analyse the impact of this crisis and to estimate the impact of a possible future crisis, an *Intervention Analysis* approach has been used. This particular technique is used to assess the impact of a special event on the time series of interest. In this case, the special event is the crisis of 2007-2008, and the time series of interest is the GDP growth of Bangladesh over the period 1981-2011. The main focus is to estimate the dynamic effect on the mean level of the series (Box and Tiao 1976).

As discussed by Box and Tiao (1976), an intervention model is of the general form:

$$Y_t = V(B)I_t + N_t \quad (1)$$

Where I_t is an intervention or dummy variable defined as:

$$I_t = \begin{cases} 1, t = T \\ 0, t \neq T \end{cases} \quad (2)$$

The present financial crisis is unique in that it was initially triggered in July 2007, and then spread to Europe and the rest of the world. It started to affect Bangladesh in 2009 (ODI 2010). I_t = 1 is thus defined for the occurrence of the global financial and economic crisis, and I_t = 0 otherwise.

The following Vector Autoregressive (VAR) model was constructed:

$$GDP_t = \beta_0 + \beta_1.\exp + \beta_2.Manuf + \beta_3.Govt + \beta_4.CropYield + \beta_5.GFC + \varepsilon_t \quad (3)$$

Estimates from the VAR model suggest that the occurrence of the global financial crisis in 2009 resulted in a 0.59 per cent decline in the GDP growth rate of Bangladesh; this variable is statistically significant at the 5 per cent level. Thus, Bangladesh could have achieved a GDP growth of 6.3 per cent in FY2008-09.

Estimation results also suggest that export growth and crop yields have been the major drivers of economic growth in Bangladesh over time. Government expenditure has a negative coefficient; however, this variable is statistically insignificant. One possible reason could be the 'crowding out' effect of government borrowing required to increase public expenditure.

Using an Autoregressive integrated moving average (ARIMA) model, it was also attempted to trace out the impact of the forecasted crop yields by the Bangladesh Bureau of Statistics (BBS) and an inflation rate of 14 per cent. Results suggest that in this case a 4.09 per cent increase in crop yield in FY2011-12, would increase the GDP growth rate in Bangladesh by 0.19 per cent. Although statistically insignificant, an increase in inflation to 14 per cent would decrease the GDP growth rate in Bangladesh by 0.012 per cent.

Source: Bhattacharya and Dasgupta (2012).

The current Euro debt crisis is yet to make any tangible mark on Bangladesh's exports performance to the Eurozone. Bangladesh's exports to 'troubled' European nations (e.g. Spain and Italy[10]) remained strong. At the same time, her major trading partners (e.g. Germany, UK and France[11]) have managed to avoid any major downturn. The revised rules of origin (RoO) under the EU-GSP (Generalized System of Preferences) scheme may have also contributed to this strong export performance in the EU, particularly favouring export of woven wear. The spillover effect of the global economic slowdown on overseas employment and remittance inflow may not be very high, as about two-third of the remittance flow to Bangladesh originate from the Middle East. Though the outlook for FDI inflow is not bleak but much will depend on domestic investment situation. As one would recall, the crisis of 2008 had a lagged adverse impact on the Bangladesh economy. However, at the same time the Bangladesh economy benefited from low prices of key commodities in the international

[10]The share of Spain and Italy in Bangladesh's export to the EU is around 17 per cent.
[11]The share of these three economies together in Bangladesh's export to the EU is around 58 per cent.

market. This time around, indications are there that commodity prices for import-dependent commodities (e.g. oil, foodgrains, edible oil, urea, etc.) will not come down in any significant manner. Compared to 2008, relatively weak state of macroeconomic fundamentals has narrowed Bangladesh's fiscal and monetary space and policy choices. This will need to be taken in to cognisance as Bangladesh prepares for any adverse consequences of a likely double-dip recession in the near-term future.

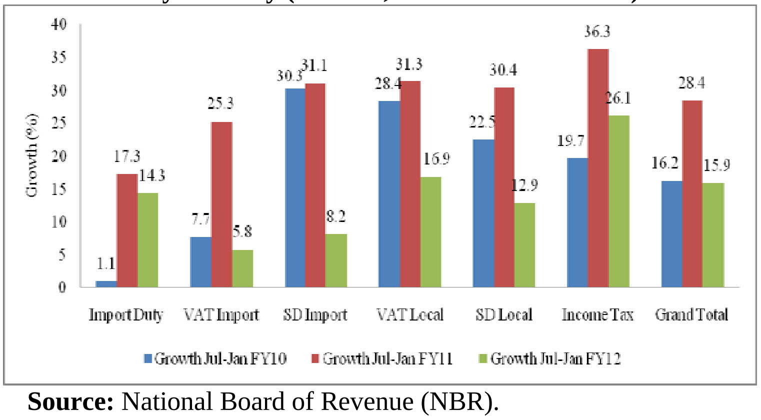
3. PUBLIC FINANCE: THE WEAKEST LINK

During the early months of the current fiscal year, expenditure pressure mounted up in the economy which was, to an extent, the continuation of the previous fiscal year. The result was high bank borrowing by the government as foreign financing was not coming through. The government needed to go for some fiscal consolidation, particularly through a reduction of subsidies, and strengthened revenue mobilisation efforts. The current trends, however, indicates the presence of previously observed fault-lines. Revenue growth has lost some pace, expenditure growth has further escalated, and the pressure on banking sources for deficit financing still exists with the potential threat of private sector getting crowded out. Foreign aid flow has faced setbacks with little or no progress in overcoming complexities of large aid commitments. The following section discusses some recent developments on public finance in details.

3.1 NBR Losing its Shine

Amidst the substantial expenditure pressure and low inflow of foreign aid in the recent past, the National Board of Revenue (NBR) with its impressive performance has been one of the very few sources of respite for the government. In the current fiscal year, however, some slowdown in NBR revenue growth is noticeable. Although the first seven months (July-January) of the current fiscal year recorded a growth of 15.9 per cent, fulfilling the annual target of 15.7 per cent, the achievement this year does not appear to be so impressive if put against the achievement of the comparable period of the previous fiscal year (28.7 per cent). Indeed, in all major sub-heads of NBR revenue, significant slowdown is evident (Figure 3.1). Though the high benchmark growth of FY2011 had some impact on this, the current growth is even lower than that of FY2010 (July-January). Overall, with five months remaining in the current fiscal year, NBR has managed to collect Tk. 46,349.9 crore in revenue, which is 50.5 per cent of its annual target.

Figure 3.1: Growth in NBR Revenue Collection during July-January (FY2010, FY2011 and FY2012)



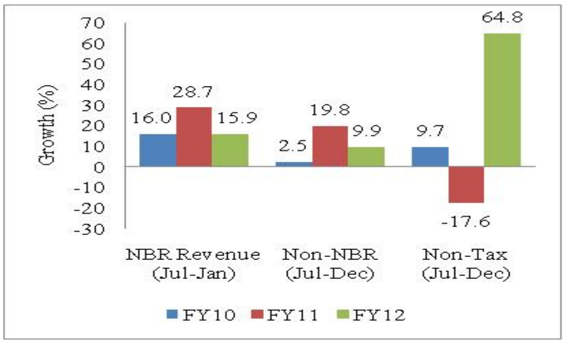
Source: National Board of Revenue (NBR).

Income tax collection, however, has remained strong with 26.1 per cent growth recorded for the July-January period which is higher than the annual target of 19.8 per cent. On the other hand, major concern is being emerged from the slowdown of revenue collection at the import stage as collection of import duty, VAT (Import) and Supplementary Duty (Import) have recorded lower than targeted growth. It is to be noted that revenue collection at the import stage constitutes about one-third of the total NBR revenue. With imports slowing down, which is anticipated to remain weak in the coming months with restrained import financing of non-essential luxury products, NBR might just approach, or even miss, its annual target this year. Although these non-essential luxury products[12] only account for around 3 per cent of total imports (in value terms) of Bangladesh, their contribution to revenue earnings is higher as these are subject to higher tariffs. Fuel import[13], however, is likely to rise further as indicated by substantial growth in its L/C (letter of credit) opening, which might ease the pressure to some extent (see section 6 for further discussion on this).

3.2 Non-Tax Revenue Records Improvement and Non-NBR Tax Collection Slows

Non-tax revenue[14] collection, which accounts for about 14 per cent of total revenue intake, has shown substantial improvement, registering 64.8 per cent increase during July-December period of the current fiscal (Figure 3.2). The budget for FY2012, however, set a 70.7 per cent growth target for non-tax revenue collection. But given the fact that revenue collection under this head experienced a secular decline since FY2006 (baring FY2010), achievement thus far remains impressive.[15] However, it is also to be noted that one single source, i.e. spectrum and license renewals fees from the mobile network operators have contributed to the observed improvement in this regard.[16] As these are one time payments, it will be difficult to sustain the current trend of improvement.

Figure 3.2: Growth in Three Components of Government Revenue



Source: National Board of Revenue (NBR) and Ministry of Finance (MoF).

On the other hand, collection of non-NBR tax,[17] which constitutes around 3.5 per cent of total revenue earnings of the government, slowed down quite considerably during the first six months (July-December) of the current fiscal year. Against 17.8 per cent annual growth in

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[12]A list of 191 products has been classified as luxury items by the NBR.
[13]Fuel imports (in crude or refined forms) are subject to total tax incidence ranging between 30-90 per cent.
[14]Components of non-tax revenue include 'dividend and profit', 'post office and railway' and 'interest/fees/tolls and other receipts.'
[15]Between FY2006 and FY2011 share of non-tax revenue in total revenue declined from 20.1 per cent to 14.3 per cent. Indeed, in FY2011 non-tax revenue collection registered a negative growth of (-) 1.3 per cent.
[16]About Tk. 3,177 crore has already been paid. Another Tk. 900 crore remains to be paid soon.
[17]Components of non-NBR tax include narcotics and liquor, vehicles, land and stamp.

FY2011 and a target growth of 21.2 per cent for FY2012, this revenue head recorded only 9.9 per cent increase during this period.

3.3 Revenue Expenditures Overshoot Hefty Targets

According to the targets set by the budget, revenue expenditure of the government was to rise by 12.4 per cent in FY2012. However, during July-December period, a substantially higher growth of 35.3 per cent has been recorded. Except for Block Allocation, all major heads of revenue expenditure overshot targets by significant margins. For example, growth in Pay and Allowances*:* 12.5 per cent (annual target 8.8 per cent), Goods and Services: 34.7 per cent (annual target 16.9 per cent), Interest Payments: 28.5 per cent (annual target 15.5 per cent), and Subsidies and Current Transfer: 52.3 per cent (annual target 10.2 per cent).

Within subsidies and current transfer, subsidy payments (excluding those to public institutions such as Bangladesh Petroleum Corporation (BPC) and Power Development Board (PDB)) experienced a three-fold increase (300 per cent) over the subsidy expenditure during July-December period of FY2011. This has taken the share of subsidies to 11.8 per cent within total revenue expenditure for the July-December period of FY2012, while the comparable figure for FY2011 was only 4 per cent.

Along with subsidies, domestic interest payment is gradually emerging as a major concern. In the first half of FY2012, interest payments (domestic and foreign) have constituted 21.2 per cent of total revenue expenditure, where domestic interest payment alone was 19.9 per cent. Domestic interest payment constituted 17.5 per cent and 19.6 per cent in FY2011 (July-June) and FY2010 (July-June) respectively. Indeed, the high bank borrowing of the government during the recent past will add to the pressure on public debt servicing liabilities in the future (reiterated in Section 4 on Monetary Policy). If the current trends continue, the size of public debt of Bangladesh, which now stands at around 39 per cent of the GDP[18] could soon become a major concern.

3.4 Substantial Rise in Subsidies to Public Institutions

Subsidies to public institutions, including those to BPC, PDB, Bangladesh Jute Mills Corporation (BJMC) and others, are included within the expenditure category of Loans and Advances which remains outside of the revenue expenditure account. This head experienced a sharp rise during the first half of the current fiscal year. Net expenditure on loans and advances stood at Tk. 5,914.0 crore, which was only Tk. 145.8 crore during the same period of the previous fiscal year.

PDB has already submitted its revised subsidy requirement of Tk. 7,200 crore (from the original estimate of Tk. 5,200 crore). They now apprehend that total subsidy requirement (by PDB) could reach Tk. 8,000 crore this year. During the first six months of FY2012 Tk. 3,000 crore has already been used by the parastatal. According to different reports, agriculture (including electricity, diesel and fertiliser) subsidy is likely to exceed its allocation (originally of Tk. 4,500 crore) for the year. As BPC is expecting fuel import to be almost doubled this year owing to demands from the rental power plants, a much higher subsidy might be needed by the end of the fiscal year. BPC anticipates a subsidy requirement over Tk. 20,000 crore

[18]Domestic debt as a percentage of GDP was 20 per cent in FY2011, 20 per cent in FY2005 and 16 per cent in FY2000; foreign debt was 19 per cent, 32 per cent and 34 per cent respectively.

this year (against original target of Tk. 3,500 crore), although the administered price has been revised four times during this fiscal year.

Adding to the difficulties, fuel prices in the international market are showing substantial upward movement very recently; crude oil prices rose by almost USD 13 a barrel only between January and mid-February with mounting crisis in the Middle East. Although global economic outlook is anticipated to suffer a downturn, it is expected that oil prices will remain high (crude oil price to average around USD 100/barrel in 2012) during the remaining months of the current fiscal year. Moreover, significant depreciation of Bangladeshi Taka (BDT) against the United States Dollar USD (by 11 per cent this fiscal year) is also marking its impact on subsidy requirements.

3.5 ADP Lacklustre as Usual

In contrast to non-development expenditures, off-take on the account of Annual Development Programme (ADP) recorded lower than targeted growth during July-January period of the current fiscal year. The targeted ADP of Tk. 46,000 crore requires ADP expenditure to grow by 40.1 per cent in the current fiscal year; the achieved growth so far has been 24.9 per cent. During the first seven months, 34.3 per cent of the ADP implementation has been achieved (this was 32.8 per cent in the comparable period of the previous year). The implementation rate is observed to be marginally better, if not similar, for the ministries with largest ADP allocations.

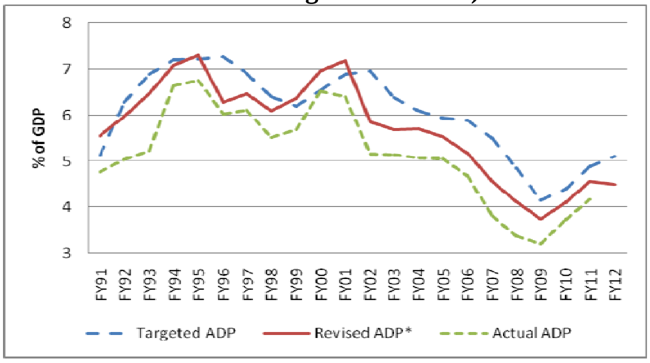
In view of growing bank borrowing by the government as well as the pressure on thebalance of payment (BoP), it is of critical importance that the status of aid utilisation in the ADP projects be improved. This is also crucial for the release of the committed aid in the pipeline, cumulative amount of which is now approaching USD 13 billion. Regrettably, no substantial improvement is visible regarding the utilisation of project aid in the current year. Indeed, implementation of the aid component remains much lower (24.1 per cent of project aid allocation[19]) compared to the Taka component (41.3 per cent). Apparently the stagnated negotiation on Padma Bridge has affected overall aid implementation rate. While 40.6 per cent of the ADP for this fiscal year was targeted to be financed from foreign aid, expenditure pattern till January shows that aid component has constituted only 28.5 per cent of the total ADP expenditure. This has affected not only the overall ADP implementation, but also created additional pressure on domestic resource basket.

Low aid utilisation has compelled the government to consider downsizing the ADP, and to rethink its financing composition for this year as well by bringing down the target of foreign financing. The 'Resource Committee' of the government has already hinted on an ADP cut for the current fiscal year by around Tk. 5,500 crore. This will get the ADP-GDP ratio down to 4.5 from its original target of 5.1[20] (Figure 3.3). As is known, the downward revision of the ADP of FY12 will be done by replacing the aid components from some projects by increasing the contribution from local financing, which will obviously add to the pressure on public expenditure. Although the revision is yet to be completed, in 14 Executive Committee of National Economic Council (ECNEC) meetings till mid-February, 115 new projects (with a total project cost of Tk. 1,39,700 crore) were approved, which will make their way into the

[19]This was 22.4 per cent during the comparable period of FY2011.
[20]According to final figures for FY2011, ADP-GDP ratio was 4.2 per cent.

revised ADP this year. Notably, Project Aid (PA) components of these projects constitute only 24.5 per cent of their total cost.

Figure 3.3: ADP as a Percentage of GDP (Target, Revised Target and Actual)



Source: Implementation Monitoring & Evaluation Division (IMED) and Ministry of Finance (MoF).
Note: *Preliminary estimates for FY2012

It is also to be noted that top 10 ministries with largest project aid allocations in FY2012 (9 of which are also those ministries with largest overall ADP allocation) have recorded better than average overall implementation performance (37.8 per cent). If *Bridges Division* is excluded from this equation (as complexities in Padma Bridge financing has held back its implementation status), average implementation rate for the remaining nine becomes 41 per cent. Although ministries with largest allocations of project aid have managed to do relatively better in terms of overall implementation, significant gap between their utilisation rate of the Taka component and the project aid component is evident. This could be indicative of the priorities that are attached with the aided projects, the complexities of releasing committed aid, the fact that utilisation of aid is also subject to the overall implementation capacities of ministries, and perhaps also the relaxed evaluation yardsticks used in releasing the Taka component.

Overall, as it appears, once again, in FY2012 one is not going to observe the much desired improvement in ADP implementation in any significant way. Rather, financing composition of the ADP is likely to deteriorate further with the contribution of foreign aid being more marginalised. Apparently, with the slowdown in foreign aid flow, the ADP for this fiscal year is switching to a more self-financed one, aggravating pressure on government's need to borrow from domestic sources, particularly from the banking system.

3.6 Significant Rise in Total Public Expenditure

During the July-December period of the current fiscal year total public expenditure stood at Tk. 62,063.4 crore, which is substantially higher (by 57.5 per cent) compared to the total expenditure incurred by the government during the matching period of the previous year. It is to be noted that high expenditure growth outside revenue and development categories, namely in food account operations and loans and advances (including subsidies to public institutions), has been a major driver of the higher public expenditure this year. These two accounts recorded 472.9 per cent growth during the first half of the year and have contributed 37.5 per cent in the total additional public expenditure this year. (Table 3.1)

Table 3.1: Share and Growth in Expenditure Categories

(in Per cent)

Expenditure	Share FY11	Share FY12 B	Share FY12 (Jul-Dec)	Growth FY12 (Jul-Dec)	Incremental Contribution FY12 (Jul-Dec)
Annual Development Programme	25.9	28.1	17.0	37.2	12.6
Non-Development Expenditure	66.6	65.7	66.4	37.8	49.9
Food Account Operation (net) and Loans & Advances (net)	7.5	6.1	16.6	472.9	37.5
Total Expenditure	***100.0***	***100.0***	***100***	***57.5***	***100.0***

Source: Ministry of Finance (MoF).

As such, increase in public expenditure in FY2012 is likely to outpace revenue growth by a substantial margin. In the absence of required inflow of foreign aid, financing composition of the higher deficit is set to deteriorate.

3.7 Heavy Bank Borrowing Continues

During the July-November period of the current fiscal year, balance between revenue earnings (excluding foreign grants) and total public expenditure recorded a deficit of Tk. 6,193 crore, which was 13.4 per cent of the total expenditure. This is in contrast to the previous year when a budget surplus to the tune of Tk. 987.7 crore was recorded. However, in financing the deficit of the current year, the government has borrowed a significant amount of Tk. 15,336.6 crore from the banking system (Table 3.2). Two factors underpinned this high bank borrowing. *First,* foreign financing that has been projected in the budget did not materialise. During the first five months of the current fiscal year, only Tk. 112.5 crore of foreign grants have been received (against the annual target of Tk. 4,938 crore). On the other hand, during this period receipt of foreign loans has been negative, Tk. (-) 48.4 crore (against the annual target of Tk. 13,058.3 crore), as amortisation exceeded receipts. This has resulted in an overall negative foreign contribution in financing the deficit. *Second,* non-bank borrowing of the government has been negative and to the tune of Tk. (-) 9,275.5 crore. Within non-bank borrowing, net sale of National Savings Bond (NSD) certificates has contributed only Tk. 488.1 crore during the first five months against the annual target of Tk. 6,000 crore.

Table 3.2: Deficit Financing Situation (July-November)

Crore Taka

Description	**Actual FY11**	**Budget FY12**	**FY11 (Jul-Nov)**	**FY12 (Jul-Nov)**
Foreign Grants	1,306	4,938	127	113
Foreign Borrowing: Net	3,267	13,058	(395)	(48)
Foreign Loan	8,694	18,685	1,661	709
Amortisation	(5,427)	(5,627)	(2,055)	(757)
Domestic Borrowing	29,964	27,208	(710)	6,061
Bank Borrowing (Net)	25,210	18,957	3,610	15,337
Non-Bank Borrowing (Net)	4,754	8,251	(4,319)	(9,276)
National Savings Schemes (Net)	1,802	6,000	1,997	488
Others	2,952	2,251	(6,316)	(9,764)
Overall Deficit (Excl Grants):	*34,537*	*45,204*	*(978)*	*6,125*

Source: Ministry of Finance (MoF).

Note: Figures in parenthesis indicate negative values.

With negative foreign financing and negative contribution of non-bank sources, the government had to go for a significantly higher bank borrowing to service the high expenditure growth in the first half of FY2012. According to the latest available information, total bank borrowing of the government came down to Tk. 17,200 crore on 5 March 2012 from its peak of Tk. 21,321 crore on 4 December 2011. Given the additional space for government borrowing created by the MPS, it seems the situation may again get reversed.

Taking note of the four indicators (total revenue, public expenditure, flow of foreign financing and non-bank financing), one may not observe any slowdown in bank borrowing in the coming months. NBR achievements seem to be moderating. Non-ADP expenditures are also skyrocketing. Expenditures on domestic interest payments are growing, and the current bank borrowing by the government itself will make the cumulative payment requirements even higher. Subsidy requirements, showing no downward trend with fuel and fertiliser prices are projected to remain high in the international market during the rest of the year. As for foreign aid flow, complexities in releasing major donor commitments (specifically the funding of the Padma Bridge and the Indian credit) are yet to be resolved. Other projects are also not showing any improvement in aid utilisation. Non-bank financing is also not readily available to the government with net sale of NSD certificates declining.

The only balance that is expected to improve is the 'Other' account[21] under non-bank financing which is currently showing a high repayment of Tk. 9,763.6 crore. But improvement in this account alone is unlikely to withstand the deterioration in the other three. The government is already planning to increase its bank borrowing target to Tk. 25,700 crore, up from the original target of Tk. 18,957 crore.

As the trends indicate, overall deficit in this fiscal year could approach, or even exceed, the targeted level of 4.3 per cent of GDP, which was 3.3 per cent in the previous year. Even then, the level of deficit should not be a matter of concern. What is of more importance from the perspective of growth and investment is the composition of the financing which needs strengthened support from the non-banking and foreign sources. The government has recently adjusted the rate of returns on NSD certificates upward[22], which was long due. This may lead to some strengthening of the non-bank financing part. But more importantly, as reflected from the fall in foreign aid inflow and its impact on deficit financing, Bangladesh remains dependent on foreign aid to a considerable extent. As such, to avert the unsustainable level of bank borrowing, at the current state there is no alternative to increase the flow of foreign aid.

[21]This balance is expected to become positive (receipt) by the end of the year, improving the current state of non-bank financing. This 'other' account is comprised of State Provident Funds, Renewal, Reserve & Depreciation Funds, Deposit Accounts, Current Assets and Suspense Accounts. This account usually remains highly volatile over the months of a fiscal year, and settles somewhere near the target by the end of the year, which is, in the case of the current year, Tk. 2,250.8 crore. For example, in the last fiscal year as well, a net negative repayment of Tk. (-) 6,316.0 crore was made during the July-November period and settled at Tk. 2,952.3 crore by the end of that financial year.

[22]In the range of 1.3 to 1.8 points.

To this end, the government has gone for the IMF support with a number of strings attached.[23] The Indian suppliers credit which is again subject to stringent conditionalities has already proved to be difficult to implement (Box 3.1).

Box 3.1: The State of Indian Line of Credit (LoC) to Bangladesh

In 2010, India announced a suppliers line of credit (LoC) worth USD 1.0 billion (1.75 per cent interest per annum), for a range of projects, including, amongst others, railway infrastructure, supply of locomotives and passenger coaches, procurement of buses and dredgers, and development of transshipment facility at Ashuganj. It is to be noted that the Indian LoC is the largest amount ever offered by India to any country. There are, nevertheless, many conditions attached with the LoC on how it is to be spent (projects related to connectivity), how the goods and services are to be procured (85 per cent source of procurement from India), and a fee at the rate of 0.5 per cent to be levied on any unutilised amount of the disbursed LoC. Bureaucratic delays in India and the stringent conditionalities in the procurement procedures have inhibited Bangladesh from fully accessing the LoC.

Initially, 20 projects (USD 927 million) were identified for possible funding. By November 2011, 14 projects (USD 718 million) were already endorsed. In contrast, so far (until February 2012) only one project (USD 36.85 million) has been implemented by the Bangladesh Road Transport Corporation (BRTC) in procuring buses from India. With regard to the remaining 13 endorsed projects, four have already been dropped (USD 234 million), and Bangladesh is yet to hear from India on eight of the projects (USD 327 million). At present, the Government of Bangladesh (GoB) is recruiting consultant for conducting the feasibility study on the project C*onstruction of 2nd Bhairab and 2nd Titas Bridge with Approach Rail lines*. The six remaining non-endorsed projects (USD 209 million) have been dropped as well (Annex Table 3.1).

Apparently the conditionalities attached with the loan are proving to be too heavy to bear. From the current status of the projects, it is doubtful to what extent Bangladesh will be able to utilise the loan. The fate of the remaining projects need to be settled at the earliest as delayed implementation will also add to the project cost.

Floating sovereign bond is also being considered which is not going to be cheap and could impact negatively on the foreign debt situation (Box 3.2). However, what is of more importance is to harness the accumulated aid in pipeline. Indeed, this depends on the government itself more than the development partners. The need for improvement on the glaring weaknesses in terms of implementation capacity of the line ministries must be addressed. The Economic Relations Division (ERD) has identified a number of factors[24] hindering the implementation of the aided projects that demands immediate and serious attention of the government.

Nevertheless, the current high growth in public expenditure appears to be unsustainable as it is unmatched with a similar rise in public revenues. Therefore along with the needed change in the composition of its financing, some fiscal consolidation is called for.

[23]Under IMF's Extended Credit Facility, Bangladesh government has to undertake certain near-term macroeconomic policies and growth-critical structural reforms. Conditions put forth by IMF include: drafts of new VAT and income tax laws to be placed in the parliament in June, withdrawal of the ceiling on lending rate and increasing the repo rate, establishing a monitoring framework to reduce loss incurred by BPC, Bangladesh Chemical Industries Corporation (BCIC) and PDB, demutualisation of Stock Exchanges, formulation of a definitive plan to clearly delineate the approval and implementation process of the ADP, amendment of the Banking Companies Act, and adoption of an automated adjustment mechanism for retail petroleum prices allowing full pass-through of international prices.

[24]Identified weaknesses in implementing aided projects include unfamiliarity of the donor agencies with the local procurement guidelines; delay in supply of manpower, data and information, other logistics and delay in land acquisition by the GoB; lack of access to donor agency's staff; change and delay in appointment of consultants; complexities in multidonor projects; lacking English proficiency among Project Directors (PDs) etc.

Box 3.2: Sovereign Bonds: Addition or Reduction to Current Economic Predicament?

A sovereign bond, in general terms, is a debt instrument issued by a national government denominated in a foreign currency with credit ratings affecting its yield rate (interest rate). Sovereign bonds have been issued by developed economies for quite a long time now, while the application of sovereign bonds has been taken up by some of the developing countries in the recent years. It has been reported that the GoB is contemplating to float sovereign bonds in the range of USD 500 million in the international market to generate investible resources, particularly in foreign currency. Bangladesh has received a 'BB-' rating (with a stable outlook) by two credit rating agencies, namely Moody and Standard and Poor in 2010, 2011 and again in 2012. Such an assessment by the international credit rating agencies has addressed one of the primary requirements of a country aspiring to raise capital from the international market.

Admittedly, fund raised through sovereign bonds will be much costlier than concessional ODA. But how much dearer a foreign currency loan underwritten by a sovereign bond would be, is a question worth looking at. GoB plans to float the bond in the international market at an interest rate of 5 to 5.5 per cent. Is this rate feasible? Bangladesh can refer to the neighbouring countries in this regard. Sri Lanka got a rating of 'B+' from Standard and Poor and 'B1' from Moody's. The third international sovereign bond amounting USD 1 billion was offered by Sri Lanka in 2011, with a yield rate of 6.25 per cent. Sovereign bond issuance in Sri Lanka was a major success as the bonds were oversubscribed in each of the three times by a huge margin. Interest on the latest Indian government bond is 9 per cent with a maturity period of 10 years. India has a higher credit rating than Bangladesh. Conversely, both Pakistan and Sri Lanka have lower credit ratings than that of Bangladesh. But the interest rate on Pakistani government bond is 13 per cent (10 year bond), while that of Sri Lanka is 6.25 per cent (10 year bond). Sri Lanka, although having a lower credit rating than both India and Bangladesh, is issuing bonds at a comparatively lower yield. The reason could be the recent stable outlook of Sri Lanka as a result of the end of the 25 year civil war. On the other hand, a very high ratio of public debt to GDP could have accounted for India's higher level of yield. In view of the above discussion, it will be difficult for Bangladesh to keep the yield rate at 5.5 per cent.

The other concern emanates from the perspective of foreign debt sustainability. With high cost of debt service payments induced by the likely high interest rate, the already felt pressure to meet interest payment expenditure could further intensify. At present, almost 19 per cent of total revenue expenditure goes to service the interest payments – 17 per cent for domestic borrowing and 2 per cent towards foreign borrowing. It needs to be examined what would additional debt servicing liability (DSL) on account of sovereign bond will do to public debt sustainability. Floating of sovereign bonds by the government would also entail high exchange rate risk. If the downward trend of exchange rate of Taka continues, this will have significant incremental pressure on DSL.

Additionally, if the high cost foreign borrowing is not used in specific productive capacity building, it will not generate desired flow of income in the future. Thus, the government will have to be doubly cautious in the floatation of a sovereign bond given its current macro-economic fundamentals.

In view of the above concerns, floatation of sovereign bonds cannot be a preferred choice for the government.

4. MONETARY POLICY: OFF THE TRACK

Maintaining price stability, creating effective employment and promoting economic growth are the three policy objectives that any central bank in the world would like to achieve, and Bangladesh Bank is no exception. However, an inherent trade-off between price stability and promotion of real GDP growth with high employment cannot be undermined[25], and thus may not be possible to achieve them simultaneously more often than not. Accordingly, a central bank requires to dramatically prioritise between its core policy objectives, namely maintaining low inflation and accelerating economic growth. Successive versions of monetary policy formulated by Bangladesh Bank over the years reiterated economic growth as its core policy priority. Nevertheless, the monetary policy in FY2011-12 seems to have assumed controlling of inflation as its core objective, even at the cost of forgoing economic growth. Measures taken as a part of the contractionary monetary policy are yet to make any visible mark. Indeed, the current monetary policy stance may undermine prospects for investment and economic growth without commensurate relief in inflationary pressure.

4.1 Cost-Push or Demand-Pull?

As in the previous fiscal year, inflation continues to remain a major concern for the economy during the first half of FY2012. General inflation reached to 11.6 per cent in January FY2012, way above the target of 7.0 per cent and last year's figure of 8.8 per cent.[26] No wonder the recent monetary policy indicated that the average inflation will be no less than 9.0 per cent in FY2012.

When compared with her South Asian neighbours, Bangladesh tops the list in terms of having the highest rate of inflation in the current fiscal year. India, Pakistan, Sri Lanka and Nepal managed to bring down their inflation rates from 9.48 per cent, 13.9 per cent, 6.2 per cent and 7.5 per cent in January FY2011 to 6.55 per cent, 10.1 per cent, 3.8 per cent and 6.8 per cent, respectively in January FY2012.

Since the mid-2000s price level of food items became the dominant contributor to inflation in Bangladesh. However, contribution of food inflation in FY2012 (July-January, FY2012) to the overall inflation declined to 64 per cent from 75.8 per cent in FY2011 (Table 4.1). Point-to-point food inflation started to slow down since July 2011, thanks to reduction of prices in the international market as well as a good harvest of Aus. On the other hand, non-food inflation remained stubbornly high and exceeded food inflation in the first seven months of FY2011-12 due to fuel price hike and its knock on impact on other sectors including transportation fare and housing.

[25]This is the classic case of so called 'Phillips Curve' effect.
[26]In January 2012, food inflation was 10.9 per cent, while non-food inflation reached to as high 13.2 per cent as opposed to their figures of 11.9 per cent and 3.8 per cent respectively in January 2011. In September 2011, general inflation reached a record high level at 12 per cent, which was highest during the last decade.

Table 4.1: Contribution of Food and Non-Food Items to General Inflation

(in Per cent)

Year	General Inflation	Food Inflation	Non-Food Inflation	Contribution of		
				Food Price Changes to Inflation	Rice Price Changes to Inflation	Non-Food Price Changes to Inflation
FY2001	1.94	1.38	3.04	41.86	14.30	58.14
FY2002	2.79	1.63	4.61	34.38	11.74	65.62
FY2003	4.38	3.46	5.66	46.48	15.88	53.52
FY2004	5.83	6.93	4.37	69.94	23.89	30.06
FY2005	6.49	7.90	4.33	71.62	24.47	28.38
FY2006	7.16	7.76	6.40	63.77	21.78	36.23
FY2007	7.20	8.11	5.90	66.28	22.64	33.72
FY2008	9.94	12.28	6.32	72.69	24.83	27.31
FY2009	6.66	7.19	5.91	63.52	21.70	36.48
FY2010	7.31	8.53	5.45	68.66	23.45	31.34
FY2011	8.79	11.33	4.15	75.84	25.91	24.16
FY2012*	11.35	12.35	9.68	64.02	21.87	35.98

Source: Based on the Bangladesh Bank data.
Note: *July 2011–January 2012.
Base: 1995-96=100. Weight: General=100; Food=58.84, Rice=20.1; Non-Food=41.16. Contribution of food/rice/non-food is calculated as the share (weight) of food/rice/non-food in general Consumer Price Index (CPI), multiplied by food/rice/non-food inflation divided by overall inflation rate.

Empirical studies on the sources of high inflation in Bangladesh indicate that factors such as food and fuel prices in the international market, growth in money supply, cost of production, exchange rate and supply shortage of agricultural commodities are major sources of inflation in Bangladesh (Majumder 2006; Mortaza 2006; Ahmed 2009; CPD 2010). Theoretically, sources of inflation are categorised in four broad groups: cost-push, demand-pull, structural and future expectation. Among the cost-push factors, a number of issues can be related to recent inflationary phenomenon *viz*. upward revisions of administered petroleum prices,[27] increasing cost of production[28] including wage rates, and depreciation of exchange rate. Average daily agriculture wage for male and female workers during the first half of FY2012 increased by 27.6 per cent and 35 per cent respectively compared to the matched period of FY2011.[29] Demand-pull factors of inflation are generally explained by the growth of credit and money supply. This is particularly associated with the non-food inflation. Interestingly, non-food inflation started to soar at a time when the central bank managed to control money supply growth to some extent (Figure 4.1). The extent of exchange rate pass-through into selling prices of imported fuel and food also needs to be assessed carefully as the sellers are blaming higher import costs for price hike and maintaining high inflation expectations. As it stands, cost-push factors along with structural impediments in the form of disrupted supply chain mismanagement due to various distortions such as cartels and local intermediaries

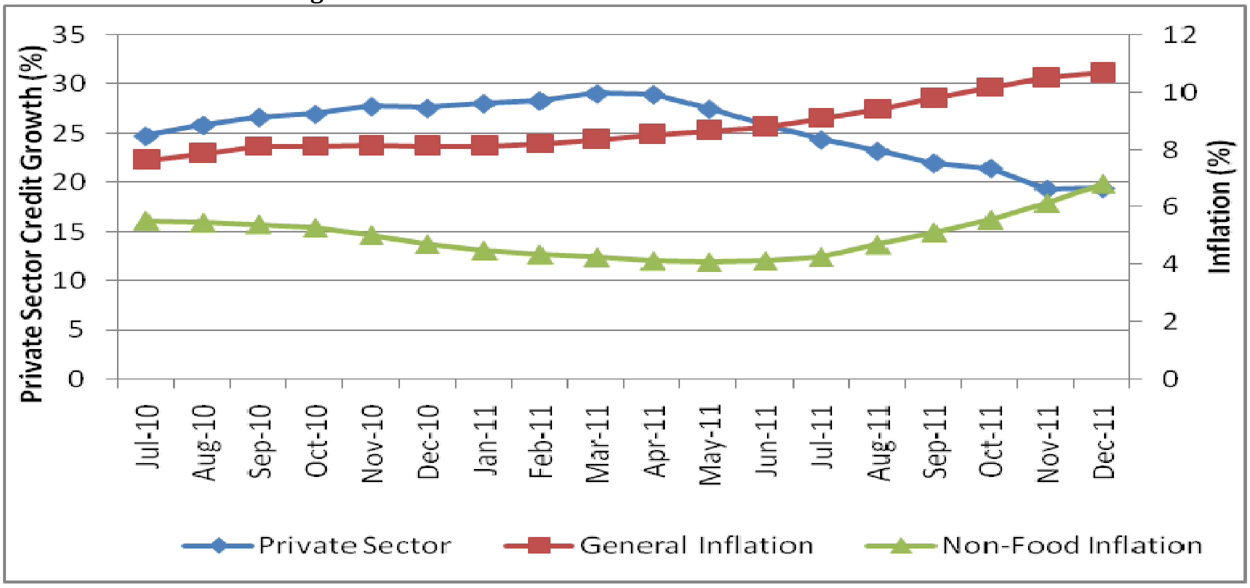
[27]Upward adjustment of recent fuel prices had impacts on inflation in both direct and indirect ways. The price hike of fuel oil contributed to non-food inflation as people had to spend more on these items. Increased fuel price also had an immediate knock on effect on other sectors such as transportation and housing. This in turn transpired in other sectors, *inter alia*, an increase in wages.

[28]The cost of agricultural input such as fertiliser, seed, wage rate and irrigation increased over time.

[29]During FY2011, average agriculture wage rate also increased substantially, by 27.4 per cent and 29.1 per cent for male and female workers respectively.

(Osmani 2007), and ongoing high inflation expectation in Bangladesh are the likely dominating demand-pull factors.

Figure 4.1: Private Sector Credit Growth and Inflation



Source: Bangladesh Bank and Bangladesh Bureau of Statistics (BBS).

4.2 Contractionary for Private Sector, Expansionary for Government!

Deviating from its earlier stand on following a so called 'accommodative' monetary policy the Monetary Policy Statements (MPS) of Bangladesh Bank for FY2012 (July-December 2011 and January-June 2012) declared 'restrained' policies for FY2012 to bring the inflation down to a 'single digit' through off-putting the growth of money supply. In effect, 'contractionary' monetary policy focused on controlling inflation through demand management. Bangladesh Bank has been applying various policy instruments to rein inflation, without making any visible heady way though. The repo and reverse repo rates have been increased from 5.5 per cent and 3.5 per cent to 7.75 per cent and 5.75 per cent respectively during this period. The Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) remained unchanged during the period under consideration.

Besides, Bangladesh Bank has increased loan margins to discourage credit for real estate and personal use.[30] The central bank has also de-capped the lending rate on bank borrowing (except for credit for export and agriculture) on January 2012 to allow banks to fix interest rate on demand-supply basis. Following this decision, interest on both deposit and credit increased. Accordingly, Bangladesh Bank again intervened with a circular that advised to fix interest rate in a 'rational manner.' The Association of Bankers, Bangladesh (ABB) announced 'self-imposed' caps for their interest rates on deposit and credit at maximum of 12.5 per cent and 15.5 per cent respectively. However, there are allegations of offering

[30]Bangladesh Bank decided that loan-margin ratio for fresh loans should be maintained at 70:30 (previously 80:20) in case of housing finance under consumer financing, and 30:70 (previously 50:50) for all other consumer loans including motor car loans.

interest rates on deposits higher than the announced rate by different commercials banks.[31] More recently, the central bank has asked the commercial banks not to pay interest rates higher than the ones announced by them. The central bank has also issued show cause notices on three state-owned banks for their alleged violation of declared interest rates on term and fixed deposits.[32] The weighted average of interest rate spread was 4.28 in January 2012. Though this is well within the target of 5 per cent, there are complaints against banks for exceeding the spread limit on a case to case basis. Indeed, business community also complained that the interest rate on lending is not within the 'self-imposed cap', and it varies between 17 to 19 per cent. Increased interest rate on lending is also contributing to rising cost of production which will have an adverse impact on both economic growth and inflation. It is apprehended that the high level of interest rate coupled with delayed gas and electricity connections to the industries may result in new loan defaults.[33]

The operational targets for monetary policy can be better understood from its monetary targeting. The MPS for July-December of FY2012, announced in July 2011, targeted to restrict money supply growth to 18.5 per cent at the end of FY2012 (from 21.3 per cent of FY2011) by reining private sector credit growth to 18 per cent in FY2012 (from 25.8 per cent in FY2011). At the end of first half of the fiscal year, the broad money growth and private sector credit growth increased to 19.1 per cent and 19.4 per cent respectively which are higher than new targets (Table 4.2).[34] Indeed, these developments were ineffective to control inflation, which continued to soar to reach the 'double digit' level during this period.

Table 4.2: Growth of Monetary Aggregates

(in Per cent)

Monetary Aggregates	FY2010	FY2011		FY2012		
	Actual	Target	Actual	Old Target	New Target	December
Net Foreign Assets	41.3	-1.5	5.3	-1.6	-8.9	-5.3
Net Domestic Assets	18.8	20.0	25.0	22.1	21.9	24.3
Domestic Credit	17.6	18.8	27.4	20.0	19.1	25.9
Credit to the Public Sector	-5.2	29.2	33.6	28.1	31.0	54.4
Net Credit to the Govt. Sector	-6.5	NA	34.9	NA	NA	73.5
Credit to the Other Public Sector	21.1	NA	28.7	NA	NA	1.7
Credit to the Private Sector	24.2	16.5	25.8	18.0	16.0	19.4
Broad Money (M2)	22.4	16.0	21.3	18.5	17.0	19.1
Reserve Money	18.1	15.0	21.1	16.0	12.2	15.7

Source: Bangladesh Bank.

[31]It appears that there is a tense competition among the commercial banks for attracting deposits from the savers. In this connection, the central bank should once again revisit the rationale to approve new commercial banks at this moment. In case of allowing establishment of new banks, the list of eligibility criteria set by the central bank must be complied.

[32]Published in *The Financial Express*, 3 January 2012.

[33]Loan default situation during last five years improved gradually. As of December 2011, percentage share of classified loan to total outstanding was 6.12 per cent which was 9.21 per cent a year ago. However, there are concerns regarding interpretations of these figures.

[34]As a matter of fact, growth of credit to the private sector (and of money supply) started to come down from the last quarter of FY2011.

Interestingly, the monetary policy for the second half of FY2012, decided to constrict private sector credit further as the target was revised downward to 16 per cent. In contrast, target for growth of credit to the public sector was revised upward from 28.1 per cent to 31 per cent. It implies, the government is now allowed to borrow about Tk. 28,000 crore (in net terms) from banking sources during FY2012 as against a budgetary target of Tk. 18,957 crore.[35] Growth rate of credit to the public sector at the end of December 2011 was a whopping 54.4 per cent along with 73.5 per cent growth for credit to government. The central bank has been helpless in the face of such a growing demand for money by the public sector.

4.3 Worse of the Two Worlds

It seems that the central bank is now focused on controlling actual monetary growth at the expense of private credit growth. That is, the central bank's monetary policy is now prioritising inflation control over growth acceleration and employment creation. However, one could see a number of fractures in this policy stance.

First, it appears that the central bank could not fully diagnose the nature of inflation. The present policies may be appropriate at a time when inflation is completely explained as a monetary phenomenon. A significant contraction in money supply growth can address demand-pull factors. As mentioned above, the present inflation is not dominated by demand-pull factors. The central bank will have to pursue a supply-side management to achieve any success over controlling inflation.

Second, there is no denying that some tightening of money supply was required. Particularly, discouraging credit flow for consumer loan and real estate by raising loan-margin ratio was a long due measure. However, a second cut of monetary growth targets (in the monetary policy for the second half of the fiscal year) may turn out to be counter-productive. A drastic monetary or credit contraction is not desirable, particularly at a time when the global economy is apprehended to fall into another recession, and the domestic investment scenario is neither much promising. This can create a further cost-push pressure on the price level. Indeed, a 16 per cent growth in private sector credit may not be sufficient to realise 28 per cent investment (as a share of GDP) and a 7.0 per cent growth.

Third, there is duplicity in the current approach of the central bank. The present monetary contraction came at the expense of restrained credit flow to the private sector, whereas the government is allowed to borrow at its will. This again throws spotlight on the sovereignty of the central bank's monetary policy. During the first six months of the fiscal year, the government absorbed one-third of the total domestic credit. Indeed, the incremental growth of money supply beyond its target is the result of excessive government borrowing from the banking sources.

Fourth, for government, the impact of interest rate rise could be an increase in debt servicing expenditure for the future generation, which is often ignored by the policymakers. On the other hand, this will affect the private sector credit and hence private investment. As a result, both growth and inflation situation may be at unsatisfactory levels. Even though some banks are proactive in keeping interest rate on deposit within its 'self-imposed' cap, there are also complaints regarding higher interest rate on lending which do not get much attention. Thus, it

[35]Considering the growth of credit to the other public sector was 1.7 per cent in December 2011. This is 47.7 per cent higher than the target set in the budget.

may create chances for windfall gains by some commercial banks and could push inflation higher.

As it stands, current macroeconomic policy stance may undermine potential economic growth and investment, but it will have a little success in controlling inflation. Without restraining government's bank borrowing, discipline in the monetary sector will be difficult to attain. Regrettably, the central bank has little control over government's budget deficit financing structure. Similarly, Bangladesh Bank has also little autonomy to ignore policy prescriptions of the IMF, which has been pressuring the central bank to adopt a contractionary monetary policy. The recent move of the central bank to go for further tightening of the monetary policy is in fact part of the conditionalities imposed by the IMF against its loan (USD 1 billion) to the Government of Bangladesh (GoB). Hence, Bangladesh Bank is posed with a difficult choice between following a tighter monetary policy and ensuring credit to the private sector to achieve the targeted growth. An independent central bank will not shy away from choosing the latter through using its armours such as repo and reverse repo.

5. CAPITAL MARKET: THE TRUST DEFICIT

5.1 Overview of the Market

The capital market of Bangladesh has passed a painful year by experiencing substantial market corrections. The bearish trend in the market which started in December 2010 prevailed throughout 2011 and in the first two months of 2012. The overpriced stocks have experienced significant loss of their values which resulted in a drastic fall of major market indicators such as price index, market capitalisation, daily trade volume and their values by about 50 to 90 per cent (Table 5.1). The average Price/Earnings (P/E) ratio at the Dhaka Stock Exchange (DSE) came down to 11.1 from the historic high of 29.2 in December 2010. During 2011, the primary market was almost unchanged – a total of 15 companies have offloaded their initial public offerings (IPOs), raising an amount of about Tk. 1,900 crore as capital.[36] After a long period of significant corrections, high volatility still persists as a major challenge, which has extended from short-term to intra-day volatilities.

Table 5.1: Major Market Indicators at DSE (01/01/2009=100)

Date (m/d/y)	Total Trade	Total Volume	Total Value in Taka (mln)	Market Capitalisation in Taka (mln)	DSI Index	DSE General Index
01/01/2009	100.00	100.00	100.00	100.00	100.00	100.00
01/03/2010	166.83	99.94	254.25	182.85	162.59	162.71
12/05/2010	389.14	371.59	754.56	351.62	318.13	317.65
01/02/2011	230.69	342.46	374.54	335.63	296.77	295.79
01/01/2012	176.42	360.17	155.49	253.88	192.11	190.62
03/08/2012	69.91	126.45	42.97	219.41	157.02	154.76

Source: Calculated based on the data from DSE website (accessed on 8 March 2012).

[36] In 2010, a total of 16 companies raised about Tk. 3,800 crore. Eight out of 15 companies listed in 2011 were related to the real sector (compared to seven out of 16 in 2010).

5.2 Measures Taken

Since the collapse of the market in December 2010, three types of measures were announced with a view to stabilise the market: a) direct injection of funds and making legal provisions for attracting more funds for increasing transactions in the secondary market (e.g. establishment of the Bangladesh Fund and the Market Stabilization Fund with special provisions for investment by banks and other financial institutions); b) amendment of existing rules and regulations and introduction of new rules (e.g. amendment of book building rule, demutualisation of Stock Exchanges, Financial Reporting Act, and mandatory holding of certain percentage of shares by sponsor directors and board of directors); and c) measures against fraudulent practices and illegal activities identified till now. These measures are to be enforced over short, medium and long-terms. At present, both the Ministry of Finance (MoF) and the Securities and Exchange Commission (SEC) are working on the implementation of measures announced by the Ministry under the directives of the Prime Minister in November 2011.[37]

It is found that short-term measures are mostly related to direct injection of fund and facilitation of institutional funds in the secondary market. Most of those measures were implemented as per the timeline except for the establishment of two mutual funds (one is partially established). The medium and long-term measures, on the other hand, are related to strengthening the legal base of the market and taking measures against illegal activities. Although a number of these measures have been initiated (e.g. investor advisory service, corporate governance guideline, etc.), implementation of those and other measures would be difficult within the stipulated timeline (i.e. March 2012). In general, the government took a 'market-based' approach to address the crisis which came under criticism on a number of accounts.[38] It has been argued in various studies and reports (CPD 2011a; CPD 2011b; Probe Committee for the Stock Market, 2011; Moazzem and Rahman 2012) that the crisis in the market is mainly originated in institutional failure, particularly of the regulatory body (SEC), which failed to monitor, operate and take actions against fraudulent and malpractices. Hence, stabilisation of the market and restoration of investors' confidence through the initiated and other proposed steps are likely to be a far-fetched goal to achieve.

5.3 Role of the SEC

Even after the reforms, SEC is yet to perform its expected role in an appropriate manner. Despite its major responsibility to regulate, monitor and oversee the market, the SEC has confined its responsibility mostly on strengthening the legal base of the market by amending existing rules and regulations. SEC has posted a total of 14 draft Acts on its website for comments from the public. The effectiveness of the proposed amendments will be judged by the level of efficiency of the SEC in identifying market irregularities and taking appropriate measures. However, such amendments of existing rules should not constrain necessary investigation of the fraudulent and illegal practices that took place during 2009-2011, and

[37]As part of market reform and restoration of discipline in the market, the MoF announced a 36-point measures and SEC prepared 29-point Work Plan. The fate of those initiatives is unclear at this moment.

[38]For example, the decision to support the affected 'small investors' in the form of writing off 50 per cent of interest charged against their margin loan during January 2011 to June 2012, and allowing 20 per cent quota for new IPOs to be listed during 2012 and 2013 raised a number of questions. This includes, among others, the rational and justification to support the so called 'small' investors and benchmark level to define these 'small' investors. On the other hand, given a significant loss of capital (both personal and borrowed) and lack of investible surpluses at hand, such measures will have little impact to restore investors' confidence.

should not undermine appropriate actions as per the existing rules. On the other hand, SEC could not make progress with regard to amendment or introduction of certain important rules and regulations as per commitments which includes demutualisation of Stock Exchanges, and insider trading and financial reporting. The progress on the installation of modern software at the SEC is still slow and will not meet the target date (April 2012). Although SEC has recruited a number of officers at the entry-level, the existing provision for recruitment does not allow it to recruit legal and audit-related specialists which is a major bottleneck in building SEC's in-house expertise.[39] As part of the market monitoring, SEC took measures against several brokerage houses for their involvement in illegal transactions. However, the Commission is yet to initiate a comprehensive investigation of fraudulent practices and illegal activities mentioned before, except for a few cases.

5.4 Examination of Market Anomalies

The nature and extent of market anomalies have often been overlooked by the regulators and other stakeholders due to lack of proper investigation. CPD has studied two key issues, one concerning the primary market (i.e. use of fund raised through IPOs), and the other on the secondary market (i.e. transaction behaviour of institutional investors vis-à-vis that of retail investors). In case of raising fund through issuance of IPOs, a number of anomalies were identified. These include diversion of fund to activities not stipulated in the prospectus, concealment of important and sensitive information in company's annual reports and cash flow statements, lack of satisfactory explanation provided by the auditor in the audit reports, failure of DSE and SEC to identify those anomalies before giving approval, and failure of the company board to address those issues. Most of these irregularities are in violation of various regulations put in place by the Commission itself.

The transaction behaviour of institutional investors was examined by analysing day-to-day transaction of a number of sample Beneficiary Owner (BO) accounts during 2009 and 2010. Institutional investors were found to behave like *noise traders* in the above mentioned periods which was reflected in the estimated withdrawal-deposit ratio of transactions in the sample BO accounts (Figure 5.1).This kind of *noise trading* by the institutional investors has significantly contributed to overheating of the market in 2009 and 2010. Transaction behaviour of institutional investors trading with brokerage houses was even *noisier* (withdrawal-deposit ratio was 2.14), compared to those trading with merchant banks (1.34) (Table 5.2). This raises the question regarding the nature of relationship maintained by institutional investors with the brokerage houses. On the other hand, transaction behaviour of investors maintaining omnibus accounts was found to be noisier (2.12) than those who traded through BO accounts (1.5) (Table 5.2). Transaction through omnibus accounts appears to take place due to absence of accountability and transparency.

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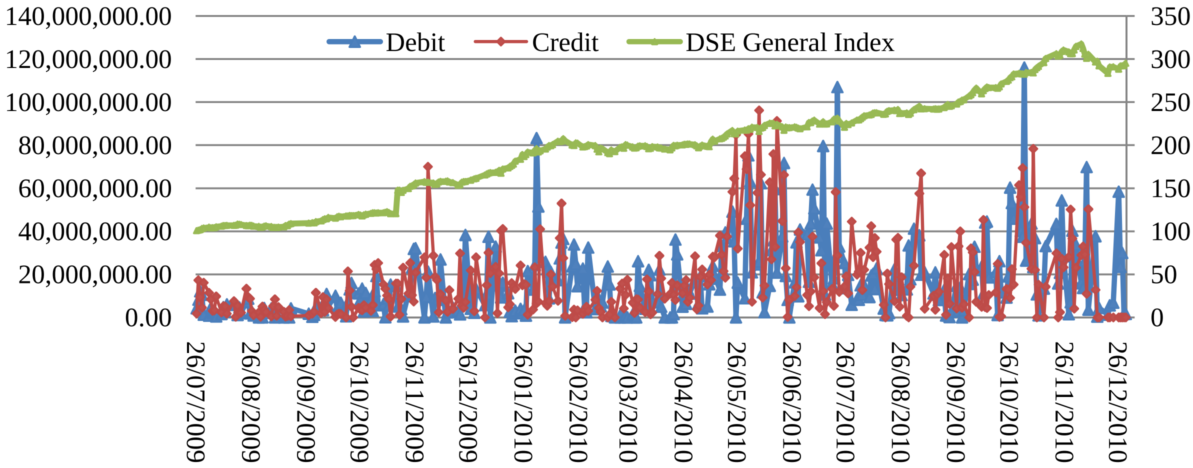
[39]A total of 19 deputy directors and some additional directors have been recruited in SEC against the targeted posts of about 60.

Figure 5.1: Daily Transaction of a Sample Institutional Investor in 2009 and 2010



Source: Based on the relevant documents.

Table 5.2: Transaction Behaviour of Institutional and Retail Investors

Investor	Number of Samples	Withdrawal-Deposit Ratio
Overall		
All	202	1.53
Institutional	70	1.58
Retailer	132	1.29
Institutional Investors dealt with		
Merchant banks	41	1.34
Brokerage houses	29	2.14
Retail Investors dealt with		
Merchant banks	106	1.28
Brokerage houses	26	1.45
Investors having accounts		
Omnibus accounts	69	2.12
BO accounts	133	1.50
Investors having omnibus accounts		
Institutional	6	1.07
Retailer	63	2.28

Source: Based on the relevant documents.

5.5 Future Directions of the Market

The current state of the market is close to what was prevailing before the pre-boom phase in early 2009 (Table 5.1). The primary market is stable and eight new companies are in the process of issuance of IPOs. However, the secondary market is still in a volatile state. Portfolio investment has registered a 22 per cent rise in FY2012 (USD 93 million in July-December 2011 compared to USD 76 million in July-December 2010). Under the current state of market, it is hard to find reasons for stocks to be overpriced under rational expectation. In other words, ongoing measures should not have any significant contribution in any artificial rise of the market. Nevertheless market is still at a dysfunctional state. Thus the market behaviour will not follow norms of rational expectation unless appropriate measures are taken to ensure discipline in the market. In order to make the market a competitively functioning one and enforce discipline in its operations, a number of measures have been suggested by CPD (CPD 2011b; Moazzem and Rahman 2012). These include the following: i) strengthening of SEC's market monitoring system, and taking actions against fraudulent and illegal activities; ii) ensuring transparency in the transaction through BO accounts and omnibus accounts; iii) taking appropriate measures to reduce insider trading; iv) enactment of the Financial Reporting Act to make audit firms accountable; v) strengthening of audit and legal activities at the SEC and DSE; vi) completion of necessary works for demutualisation in the Stock Exchanges (Dhaka and Chittagong); and vii) discouragement of short-term transaction in the secondary market. Along with implementation of the ongoing measures, government should take into consideration of the above mentioned suggestions.

6. BALANCE OF PAYMENT: UNDER SEIZE

Bangladesh's balance of payments (BOP) situation was under consistent pressure over the most part of the FY2012. In spite of good overall performance, export sector was transmitting some disquieting signals as signs of strains became increasingly visible in traditionally dependable export destinations of Bangladesh (e.g. the US market). In this backdrop, higher import growth led to a widening of the trade deficit. Remittance inflow, consistent with growth target could not keep up with the widening current account deficit. Compounded by inordinately low level of net foreign aid inflow, BOP situation came under some pressure in the period under review. Consequently the value of Taka, which demonstrated remarkable consistency over the past few years, against USD, took a severe beating, underpinned by falling foreign exchange reserves. However, both export earnings and remittances evinced considerable volatility over the July-February period. Over the last few months of the observed period, as import growth came down, and remittance and foreign aid inflow somewhat improved, BOP situation experienced some improvement, and exchange rate of Taka against major currencies regained some of its lost value. The government also made a number of policy moves to restrain deteriorating BOP situation. Nevertheless, trends indicate some volatility in every BOP parameters adding to the uncertainties emanating from the fluctuating fortunes of the global market, particularly in Eurozone countries.

6.1 Export Earnings: Volatility to Continue

The remarkable growth in export earnings in FY2010-11 started to slowdown in FY2011-12 and gradually fell somewhat short of the target set for the year.[40] While export of the readymade garments (RMG) products, which accounted for almost 80 per cent of Bangladesh's total export, paced ahead of the target, non-RMG exports failed to match this performance.[41] It is a matter of some concern that export of knit RMG has underperformed in the first seven months of FY2011-12 (July-February), registering 8.7 per cent growth; in contrast, woven garment export posted a rise of 22.2 per cent (Table 6.1). What is somewhat

[40]Total export registered a 22.6 per cent growth during Q1 of FY2012 and 14.7 per cent growth during Q2 of FY2012. Against the targeted growth of 15.6 per cent, export earnings during July-February period of the current fiscal year stood at USD 15.9 billion, which is 13 per cent higher than that of the comparable months of the previous fiscal. To achieve the growth target set for FY2012, total export earnings will need to attain 19.6 per cent growth for the rest of the months (Table 6.1).

[41]Among other non-RMG items, exports of raw jute decreased by (-) 29.5 per cent and that of jute and jute goods decreased by (-) 13.7 per cent during July-January period of FY2012.

alarming is that, in the US market, knitwear export decreased by (-) 10.4 per cent. In EU, the traditional market for Bangladeshi knit products, knit export increased by 10.3 per cent, whereas export of woven increased by a robust 35 per cent, thanks to the new rules of origin (RoO) under the EU-GSP.

If export-related imports are taken into account, net export[42] growth attained for RMG would stand at much lower level of 11.2 per cent during the first seven months of FY2012. It is to be noted here that, though volume of export has decreased, growth in RMG export was attained, mainly due to increase in export values driven by increased unit price.[43] This has somewhat stabilised the terms of trade which has experienced a fall over the recent past period.

Table 6.1: Growth Rates of Export

(in Per cent)

Product	Growth Target for FY12	Growth in FY12 (Jul-Feb)	Growth in FY11 (Jul-Feb)	Required Growth for Rest of the Year to Attain Export Target
RMG	**13.7**	**15.1**	**41.1**	**11.5**
Knit	13.9	8.7	43.9	22.0
Woven	13.4	22.2	38.0	-0.3
Non RMG	**22.5**	**6.0**	**37.6**	**50.3**
Raw Jute	30.0	-29.5	84.7	151.1
Leather	10.0	17.3	33.9	-0.6
Home Textiles	64.1	16.7	104.0	217.9
Frozen Food	16.2	3.2	58.8	45.3
Total	**15.6**	**13.0**	**40.3**	**19.6**

Source: Estimated from the Export Promotion Bureau (EPB) data.

In a welcome trend, despite of the crisis spreading over the Eurozone, total exports to the EU-27 countries posted a 17 per cent growth, while that for export of RMG was 19 per cent.[44] This was attained even as the crisis struck EU economies such as Spain, Italy and Belgium.[45] The revised rules of origin (RoO) under the EU-GSP scheme, which particularly favour export of woven wears, may have contributed to this export surge in the EU.[46] In contrast to the EU, export to the US market is in a weaker situation. RMG export in the US market posted an insignificant growth of 0.3 per cent during the first seven months of FY2012. Though growth of total RMG import by US in the first half of FY2012 was low (4.5 per cent), some major competitors of Bangladesh, e.g. Vietnam, Cambodia, Indonesia,

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[42]Net RMG export has been defined as the difference between gross RMG export earnings and payments for back-to-back L/C settlement.

[43]This value-driven growth was underpinned by rising unit prices as a result of significant rise in prices of raw materials which persisted during mid-2011 period. Cotton price stood at its peak in March 2011 (5.06 USD/kg). Over the following months, price of cotton started to fall and reached 2.09 USD/kg in December 2011. Since January 2012, prices once again started to rise again to 2.22 USD/kg and stabilised in February 2012.

[44]Germany, UK and France, where 31 per cent of global export of Bangladesh is destined to, are so far beyond the reach of the crisis.

[45]During FY2012 (July-February), export earnings increased in Germany (25.3 per cent), UK (31 per cent), Spain (35.7 per cent), Italy (27 per cent), Belgium (58.2 per cent) and France (2.6 per cent), while decreased in Netherlands (-51.8 per cent).

[46]In the EU market, exports of woven garments registered a growth of 35 per cent during FY2012 (July-February), while export growth for knitwear was 10.8 per cent.

Nicaragua, Sri Lanka and Mexico managed to attain healthy growth.[47] Considering the total export of top 10 Bangladeshi RMG products where her major strength lies, Nicaragua, Honduras and Mexico outperformed Bangladesh.[48] If competitors continue to perform better even in our traditional and dependable products in a traditionally important market, this certainly could become a matter of concern in the coming months.

Meanwhile, export earnings from non-traditional markets of Bangladesh (i.e. other than US, EU and Canada) increased by 17.9 per cent.[49] New opportunities have emerged in the Indian market, a rapidly growing export destination for Bangladeshi products. India's recent decision to exclude almost all products from its sensitive list for SAARC-LDCs including RMG items, is likely to give a phillip to Bangladesh's exports in the coming days. Realisation of this opportunity is also crucial, especially from the perspective of Bangladesh's export diversification in the Indian market. It is to be noted that almost 90 per cent of the products that Bangladesh exports to India belong to the non-RMG categories.

It is somewhat disquieting for Bangladesh's export that recently India has put a ban on its export of cotton. This may result in a rise of the domestic and international prices of cotton and yarn. This is likely to undermine the competitiveness Bangladesh's backward linkage textile industry and lead to a rise in production cost.[50] Opening figures for back to back L/Cs during the first seven months of FY2012 have decreased by (-) 15.1 per cent. In the first few months, falling back-to-back L/C growth could have been because of falling cotton prices. However, as cotton and yarn prices rise, falling back-to-back L/C growth could mean placement of lower orders by the major buyers. Thus over the next months, Bangladesh will need to examine these trends carefully. Recently, the government has formed a high level committee to investigate the deteriorating performance of some of Bangladesh's export items.[51] With the grim outlook for global growth and trade, and along with the possibility of 'double-dip' recession in Eurozone, the key exporting market of Bangladesh, and underperformance in the US market, the year-end performance of the export sector may be somewhat below the target set for FY2012.

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[47]While export of Bangladesh increased by a mere 0.7 per cent, higher growth rates were attained by her major competitors in the US market such as Cambodia (11.5 per cent), Vietnam (8.6 per cent), Nicaragua (38.6 per cent), Indonesia (9.9 per cent), Sri Lanka (15.6 per cent) and Mexico (7.8 per cent). However, exports from China, increased by 0.8 per cent, and India decreased by (-) 0.3 per cent.

[48]This group consists of the top 10 RMG products (at HS 6 digit level) which Bangladesh exported in FY2011. During July-December FY2012, Bangladesh's export of these top 10 products in the US increased by 6.3 per cent. Exports of the same products by Nicaragua increased by 44 per cent, Honduras by 17 per cent, and Mexico by 8 per cent.

[49]During the July-February period of FY2012, total export to Japan increased by 55 per cent, India by 9 per cent, Australia by 41 per cent and China by 26.2 per cent.

[50]On 5 March 2012, India has put a ban on export of raw cotton. Even import under already opened L/C has been stopped. As one may apprehend, prices of imported as well as local (Bangladeshi) yarn and cotton may increase as a result of this ban.

[51]The Committee will attempt to identify factor responsible for continuous underperformance of some export items such as tea, frozen food, leather, home textile, etc. In view of the government's target to double the country's export earnings within the next three years, the Committee will recommend necessary measures to attain the target. The government has also planned to increase incentives to diversify export basket as well as destination (for details, see <http://samakal.com.bd/details.php?news=48&action=main&menu_type=&option=single&news_id=242505&pub_no= 986&type=>)

6.2 Import Payments: Petroleum in the Driving Seat

Until November 2011, the high import growth over shadowed the moderate export performance and remittance inflow putting a significant pressure on BOP position over the corresponding period of FY2012.[52] However, in December 2011, import payments fell by (-) 2.6 per cent bringing some relief to the BOP situation (Table 6.2). During July-January FY2012, import registered a 15.6 per cent growth, while import payment for the month of January 2012 increased by (-) 9.8 per cent. Swelling import payments was primarily rooted in the higher demand for imported petroleum, thanks to the reliance on liquid fuel-based (quick) rental power plants for electricity supply. Import payments for petroleum products increased by 50.7 per cent during July-January of FY2012. As a matter of fact, almost one-third (31.6 per cent) of the incremental import payments during the first seven months of the fiscal year were attributed to imports of petroleum products.[53] This implies that the relative relief from the soaring import payments was possibly due to the lower import of refined petroleum products in December 2011. It is anticipated that the growth of petroleum import will continue to remain high, as L/Cs opening for petroleum has doubled in the second quarter of FY2012. This implies that the current high growth of import payments for oil products will be maintained over the next few months of FY2012.

Table 6.2: Import Payments

(in Per cent)

Items	Growth				Share
	Jul-Dec FY11	**Jul-Nov FY12**	**Jul-Dec FY12**	**Dec FY12**	**Jul-Dec FY12**
Foodgrains	87.6	-29.8	-30.9	-36.4	2.9
Rice	3809.6	-10.6	-8.2	28.0	1.5
Wheat	19.22	-43.9	-44.6	-46.8	1.5
Edible oil	-0.7	42.6	34.9	5.7	4.3
Sugar	-13.7	71.9	89.4	158.2	2.9
Petroleum	33.7	66.3	53.5	4.6	13.1
Crude petroleum	40.4	0.5	8.1	30.5	2.4
Petroleum and other liquids (POL)	31.8	87.5	69.4	-7.4	10.7
Chemicals	33.2	0.6	-0.4	-5.7	3.4
Fertiliser	29.7	46.8	32.8	0.6	4.7
Plastics and rubber articles thereof	40.9	5.7	5.4	4.1	3.7
Raw cotton	118.2	-20.1	-29.1	-56.4	5.2
Yarn	74.5	49.2	37.4	-13.8	4.6
Textile and articles thereof	31.4	23.9	20.0	-0.5	8.4
Iron, steel & other base metals	44.2	14.9	8.1	-19.5	5.7
Capital goods	27.1	30.7	25.8	6.0	21.4
Capital machinery	28.4	11.1	1.4	-33.5	6.0
Other machineries	19.8	40.7	38.7	30.0	15.4
Other *(not included elsewhere)*	28.2	28.9	25.3	8.9	32.9
Grand Total	36.5	21.7	16.9	-2.6	100.0

Source: Calculated from the Bangladesh Bank data.

[52] Growth of import payments in July-November period of FY2012 was 21.7 per cent.

[53] Total import payments for other products (total import less petroleum import), on the other hand, was well within the target with a growth rate of 13.1 per cent during the similar period.

Containing import growth within the target of 14 per cent for the full FY2012 will not be easy. Indeed, to attain this target growth of import in next five months of fiscal year needs to slow down further to 11.8 per cent. To discourage imports, the government is planning to curb import of 'unnecessary luxury goods.'[54] These initiatives may not bring much respite as the share of these items in Bangladesh's total import is rather small (about 3 per cent). As it stands, import growth of petroleum products will determine the final figure of import payments for the entire period of FY2011-12.

6.3 Terms of Trade (ToT): Back to the Falling Zone

Terms of Trade (ToT) of Bangladesh has long been on a declining trend before somewhat plateauing since FY2008. The situation has marginally improved in FY2011 (Table 6.3). With global recovery from the crisis, both export price and import price increased with a net positive impact on the ToT. Purchasing power of our major export items also seems to be stabilised for the time being.[55] To import a barrel of crude petroleum, Bangladesh had to export 6.0 kg of RMG in FY2011 (July-November). During the comparable months of FY2012, Bangladesh had to export almost the same amount of RMG (6.1 kg) to buy the same amount of crude petroleum. Purchasing power of RMG export has increased against import price for rice, wheat and soybean oil from the global market over the matched period.[56] However, rising commodity prices, including for fuel, could induce ToT to slip back again, remphasising the need for more emphasis on relatively high-value items in Bangladesh's export basket.

Table 6.3: Terms of Trade of Bangladesh

(Base: FY1996=100)

Year	Export Price Index	Import Price Index	Commodity ToT
FY2000	120.31	136.17	88.35
FY2001	123.15	146.41	84.11
FY2002	126.23	157.76	80.01
FY2003	135.19	164.15	82.36
FY2004	139.60	169.96	82.14
FY2005	142.38	176.66	80.60
FY2006	149.28	183.09	81.53
FY2007	165.70	232.52	71.26
FY2008	171.29	241.15	71.03
FY2009	178.23	248.33	71.77
FY2010	188.93	262.44	71.99
FY2011*	202.74	280.13	72.37

Source: Bangladesh Bank Annual Report 2010-11.
Note: *estimated.

[54]Bangladesh Tariff Commission has already prepared a list of 191 'luxurious' items. Bangladesh Bank in its latest Monetary Policy (for January to June 2012) also aimed to curb 'non-essential imports' and advised commercial banks to restrict L/Cs opening for import of 'luxury' products.

[55]To calculate the purchasing power, average export prices of Bangladeshi RMG in the US and EU markets were taken.

[56]To import 1 MT of rice, 1 MT of wheat and 1 MT of soybean oil, 36.2 kg, 19.2 kg and 36.3 kg of RMG had to be exported in FY2011 (July-November). Comparing the same months of the current fiscal, to import the same products Bangladesh had exported 34.7 kg, 18.0 kg and 31.5 kg of RMG respectively.

6.4 Overseas Migration and Remittances Inflow: An Upturn

A robust growth in remittances inflow to Bangladesh during July-February period of the current fiscal (FY2012) was underpinned by an upturn in the number of Bangladeshi workers going abroad. A large part of this story related to the outflow of migrant workers to the Middle East countries where high oil price has led to renewed economic vibrancy. Depreciation of Taka against currencies of major migrant destination countries has also helped.[57] Country-wise remittance inflows from major destinations have experienced positive growth during July-December of FY2011-12. Cost of sending remittances to Bangladesh has also declined in the third quarter of 2011 compared to that of 2010 by 14.8 per cent, for sending from Saudi Arab, and by 26.7 per cent from Singapore.[58] The number of migrant workers has improved significantly during the first eight months of FY2012 compared to the same months of last two fiscal years (FY2010 and FY2011).[59] Significant growth was posted for almost all destination countries except for Bahrain and Malaysia. Despite the grim outlook for global economic growth and remittance flow (Mohapatra *et al.* 2011), the trends indicate that remittance inflow to Bangladesh will continue to remain good. In view of this, the prospect for remittance inflow to Bangladesh in the remaining months of FY2012 looks promising. In the backdrop of the current track record this year, it is likely that the fiscal year-end target of USD 12.7 billion will be attained.

6.5 Foreign Aid: The Achilles' Heel

Slowdown in foreign aid inflow has been proved to be the *Achilles' heel* for Bangladesh in FY2012. Given an inflow of USD 1.1 billion of gross foreign aid during the first seven months of FY2012, it is now highly unlikely that the budget target of USD 3.3 billion for the full fiscal year will be achieved. On the other hand, out of the total net foreign aid inflow (USD 530.5 million) during the first seven months of the current fiscal year, 60.6 per cent (USD 321.4 million) has come to Bangladesh in the single month of December 2011. However, the pace has dropped again in January. Past experience suggests that some improvement in foreign aid inflow could happen in the coming months, as the ADP implementation (and hence its project aid component) gains momentum in the latter half of a fiscal year. However, to garner maximum potential support from this component of the BOP, there is a need for a renewed effort to disburse and utilise the foreign aid in the growing aid pipelines.

6.6 Balance of Payments: Stabilising but How Long?

It was apprehended that the pressure on BOP during the early months of FY2012 was likely to sustain throughout the rest of the year (CPD 2012). According to the new MPS by Bangladesh Bank, even an improved projection for current account balance was unlikely to be able to hold the deterioration in the overall balance situation owing to the worsening

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[57]Total remittance earnings during the above mentioned period stood at USD 8.4 billion registering a growth of 11.9 per cent. If the purchasing power of remittances adjusted for the domestic inflation, remittance growth would stand at 13.3 per cent for the same period. With the existing rate of remittance inflow, total remittance earning is likely to cross the Medium Term Macroeconomic Framework (MTMF) target of USD 12.7 billion for FY2012. To achieve the target, inward remittances will need to register an average growth of 3.7 per cent throughout the remaining months of F2012.

[58]Remittance Prices Worldwide Database, World Bank < http://remittanceprices.worldbank.org/>

[59]The number of total migrant workers going abroad during the first eight (July-February) months of FY2012 was 444,744, which was about 75 per cent higher than that of the corresponding period of FY2011.

balance in the financial account.[60] A deceleration in the financial account is likely to take place if the foreign aid flow does not register significant improvement in the coming months. A recent fall in import growth along with the increasing pace of remittance inflow and moderate export growth helped to attain a current account balance surplus of USD 409 million in December 2011. Net foreign direct investment (FDI) inflow has increased, but the rise (by USD 89 million) was too insignificant to restrain the deterioration in the financial account balance. Overall deficit has plunged to (-) USD 998 million drawing attention to the need for a considerable improvement in overall balance in the second half of FY2012 (Table 6.4).

Table 6.4: Balance of Payments

(Million USD)

Items	FY2011	FY2012 (Initial Projection)	FY2012 (Revised Projection)	FY2012 (Jul-Dec)
Trade balance	-7328	-8,846	-9034	-4195
Workers' remittances	11650	12,171	12815	6068
Current account balance	995	-884	-243	409
Capital account	600	550	300	224
Financial account	-1584	-105	-1443	-805
Foreign direct investment	768	850	850	431
Other investment	-2324	-905	-2343	-1329
MLT loans	1051	1750	850	525
Errors and omissions	-936	0	560	-826
Overall balance	-925	-439	-826	-998

Source: Compiled from the Bangladesh Bank data.

To maintain stability in the BOP, the government has allowed some of the country's private sector to go for borrowing from the international market.[61] The government has also set up a seven-member committee to find ways to float sovereign bonds in the international market. The long awaited IMF-ECF support is also being negotiated. However, one could expect that this will be accompanied by various conditionalities including market-based mechanisms for determining the domestic prices of the petroleum products. It has been reported that USD 150 million may be disbursed by June 2012 as part of the USD 1.0 billion IMF-package. Moreover, the government will perhaps need to go for financing under stringent conditions for underwriting some of its large-scale infrastructure project (e.g. the Padma Bridge; see Box 6.1). Such arrangements will entail short to medium-term risks for the country, reemphasising the need for using the funds with due diligence and efficacy. The government is far better off if the existing resources (in the form of foreign aid awaiting in the pipeline) can be used more effectively. Whilst the need for additional funds, to underwrite the needs for the growing infrastructural demand of a developing country such as Bangladesh cannot be denied, preference must be given to exploiting the opportunities of using the funds committed and those in pipeline. The cost of fund, cost-benefit analysis and returns on investments should be given due importance when alternative sources are explored.

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[60]The new forecast by Monetary Policy Statement (January-June, 2012) of Bangladesh Bank made a downward revision of all accounts, including trade balance, except for current account balance, thanks mainly to the better inflow of remittance over the next few months of FY2012.

[61]The government on 7 February 2012 approved five local private firms to acquire USD 152.8 million from offshore banks at an interest of LIBOR plus four. See http://bdnews24.com/details.php?id=217797&cid=4

Box 6.1: The Padma Multipurpose Bridge Fiasco

The Padma Multipurpose Bridge was formally initiated on 1 January 2009 following prolonged talks spanning nearly two decades. Padma Bridge project has been allocated approximately 9.1 per cent of the total project aid in FY2012. No one doubts that implementation of this particular project should receive highest priority given the benefits it will generate. It is estimated that this project will add 1 to 2 per cent to the country's GDP. Consequently, delayed implementation of this high value national project will have significant adverse impact in terms of forgone potential benefits.

As is known, the World Bank, Asian Development Bank (ADB), Islamic Development Bank (IDB) and Japan International Cooperation Agency (JICA) had agreed to combinedly finance 79.2 per cent of the Padma Bridge project (USD 2.35 billion) with respective contributions of USD 1.2 billion, USD 615 million, USD 140 million and USD 400 million. As is the case, the World Bank and other donor agencies halted the financing of the project in August 2011, on grounds of alleged fraudulent practice on the part of Bangladesh in selecting a Canadian company for project supervision.

In the face of withholding of the funds by the World Bank and other donors, the government is contemplating keeping a Malaysian public-private partnership (PPP) offer which was officially placed to the GoB in January 2012. Malaysia has offered to invest USD 2.2-2.3 billion out of the approximately USD 3.0 billion required to build the bridge. The Malaysian fund is to be raised in Dubai from not so transparent source. Some of the conditions put forward by the Malaysian counterpart include 50 years' of ownership of the Padma Bridge under build-own-operate-transfer (BOOT) arrangement, confirmation of the projected number of vehicles, provision of subsidies if the projected number of vehicles do not get realised, no additional bridges or other transport modes to be constructed around Padma Bridge that could undermine the prospects of toll collection (also the existing ferry service has to be discontinued), and prior remedial measures to take care of the human rights and environment-related issues.

A rough estimate suggests that the weighted average interest rate of the loan from the donors would be less than 1 per cent. On the other hand, under Malaysian offer, the government will have to incur an interest rate in the range of approximately 3-5 per cent depending on the rate of toll collection charge (either the toll collection and vehicle flow would be similar to that of Bangabandhu Bridge, doubling the toll rate or a 20 per cent more vehicle flow in addition to the doubling of the toll rate) for Malaysian proposal (assuming this comes as a loan). The repayment period proposed by Malaysia is 50 years, while the repayment period of the World Bank loan is 40 years. Additionally, Malaysia is not allowing any grace period, but the World Bank and other donors are allowing grace periods in the proximity of 7-10 years. Maintenance and other costs should be taken cognisance of whilst making the cost estimates in case of the Malaysian offer, but not for the loan provided by the donors. Apart from financing concerns, the capability of Malaysia in building such bridges has also surfaced. It may be pointed out that finance from international development agencies comes with some intangible benefits such as quality assurance and technical know-how.

It is obvious that the Malaysian offer will result in higher users' cost which the poor citizens may not be able to afford. Thus, the government will be well advised to settle the Padma Bridge financing controversy in a transparent and judicious manner with the international development partners at the earliest.

6.7 Exchange Rate: End of a Free Fall?

In the first half of FY2012, a growing pressure on BOP has been transmitted into depreciating exchange rate of the national currency. Exchange rate management has become even more difficult due to the volatility in the international exchange rate markets. As of end January 2012, BDT depreciated against all major currencies (USD, Euro, British Pound (GBP) and Chinese Yuan (CNY)) except for the Indian Rupee (INR).[62] This situation has reversed in February 2012, when between end of January and 7 March, BDT appreciated against all the

[62]During last seven months (between end of June to end of January) BDT lost its value vis-à-vis USD by 13.8 per cent, Euro by 3.2 per cent, GBP by 11.6 per cent, and CNY by 16.9 per cent. In contrast, between the end of June to end of December, BDT appreciated against INR by 7.2 per cent.

aforementioned currencies.[63] During this period, Bangladesh also managed to augment its hitherto depleting foreign exchange reserve. On 28 February 2012, foreign exchange reserve recovered somewhat to reach USD 9.15 billion (equivalent to 3.0 months of import payments) indicating some stabilisation in the BOP situation, at least for the time being.[64] Currently, there is hardly any room for the Bangladesh Bank to use foreign exchange reserves to intervene in the exchange market and arrest the fall in BDT's value if this does not happen through market mechanisms. It is safe to argue that in the coming months the exchange rate of BDT against major trading partners' currencies will depend on the BOP situation of Bangladesh.

6.8 Caution, Not Haste

Considering the factors which have contributed to taking some of the heat off the BOP pressure till now, one will need to carefully monitor the behaviour of major related correlates over the remaining months of the current fiscal year. Caution, not haste will be needed, since important trade-offs are involved. The fate of Bangladesh's export performance will by and large depend on the outlook for the large economies in the EU zone, though export situation in those countries have remained robust till date. However, the reasons for the dismal growth of export in the US need to be also looked at closely. On the other hand, the size of the import payments will be mainly determined by demand for petroleum products and the volatility in global of the commodities prices imported by Bangladesh. As it stands, a surge in net FDI inflow is hardly to be expected. Without strong support in the form of net inflow of foreign aid, BOP will continue to remain vulnerable. With the looming uncertainties in the developed world, external sector balances will likely to experience some pressure over the remaining months of FY2012.

Heightened attention will be needed to stimulate export and remittance flow to the economy. Appropriate measures will be required to ensure higher aid utilisation in the coming months of FY2012. This, however, will critically hinge on the ability of policymakers to maintain a conducive, production-friendly environment within the economy which is crucial for stimulating export-oriented activities and incentivise continuingly high flow of remittances to Bangladesh. Project-specific task forces will need to be constituted to ensure that funds in the foreign aid pipeline are speedily disbursed and effectively used.

7. GROWTH AND ECONOMIC OUTLOOK: LOOMING UNCERTAINTIES

Quality of Policy Making: Need for Strengthening

In November 2011, CPD's analysis of the macroeconomic performance urged the government to take into cognisance that the national economy has entered into a difficult period from the perspectives of macroeconomic management (CPD 2012). In the course of the last four months, it appears that the top policymakers have grudgingly accepted the concerned realities, often flip-flopping in their policy pronouncements.

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[63]BDT gained its value vis-à-vis USD by 3.3 per cent, Euro by 2.7 per cent, GBP by 3.3 per cent, and CNY by 3.4 per cent during this period.
[64]Foreign exchange reserve, which stood at USD 10.4 billion as of 6 March 2012, came down to USD 9.15 billion on the next day after Asian Clearing Union (ACU) payment of USD 893 million. It is to be noted that the payment of ACU against import is made every two months.

A tracking exercise of the relevant measures undertaken by the government over the subsequent period indicates that a majority of these were in line with those suggested earlier by the CPD. Please see Annex Table 7.1 in this regard. As may be noted, the government has acted on those areas (albeit in a belated way), which may be address through regulatory directives, e.g. adjustments of administered commodity prices or increase of NSD yield rates. However, there is little evidence to suggest that the government has comprehensively and coherently involved itself in dealing with the current challenges through structural reforms particularly in view of its commitments enshrined in its Election Manifesto and the Sixth Five Year Plan (2011-2016).

The need for greater transparency of the policy making process, including access to critical budgetary data (e.g. estimates of subsidy by sector) and real time information on the performance of the economy, has been highlighted by CPD in its various reports on a regular basis. It may be pointed out that according to the Article 15 (4) of *Public Money and Budget Management Act 2009*, the Finance Minister is required to present a quarterly report to the parliament regarding performance of the economy. Since the enactment of this legal obligation, during the last 10 quarters (July 2009 – December 2011), the Finance Minister placed only five such reports (see Table 7.1).

Table 7.1: Frequency of Placement of Quarterly Economic Review by the Finance Minister to the Parliament

Quarters	Status
July-September FY2010	Not reported
July-December FY2010	Reported for the first time
July-March FY2010	Reported in May 2010
July-June FY2010	Not reported
July-September FY2011	Reported in December 2010
July-December FY2011	Reported in March 2011
July-March FY2011	Not reported
July-June FY2011	Not reported
July-September FY2012	Reported in March 2012
July-December FY2012	To be announced soon according to the Finance Minister

Source: Ministry of Finance**.**

Interestingly, while during the recent past when there had been a lot of public discourse regarding the state of the economy, there was hardly any parliamentary debate on the subject. Indeed, the report on the first quarter (July-September) of FY2012 was only released in March 2012, and the second report has been promised to come out soon.

The above cited Act also requires the government to report the figures on subsidy disbursement and outstanding loans to the state-owned enterprises (SoEs) in a transparent manner. While the government is releasing the revised figures regarding subsidy allocation for the preceding year, the composition of subsidy allocation and actual expenditure for the current fiscal year is yet to come by. The said Act further advises the government to revise the annual budget by the month of March in each fiscal year. However, as the practice goes, such revisions are only announced along with the budget for next fiscal year, i.e. in the month of June. CPD in its November 2011 review strongly recommended an early revision of the budgetary targets.

The absence of credible real time data has also been affecting the quality of national policy making in Bangladesh. For example, while employment generation happens to be one of the critical development objectives of successive governments, there is no institutional mechanism in place to capture the real time employment trends, not even on an annual basis. Moreover, following recent publication of the results of a number of much awaited national surveys, e.g. Population Census, Household Income and Expenditure Survey (HIES), Labour Force Survey, some key variables including population size as well as poverty and income inequality estimates have come under critical scrutiny. Sustained high prices of foodgrains, notwithstanding successive bumper crops, have also periodically raised questions about the foodgrains production estimates. It is now to be seen how the upcoming rebasing of consumer price index and revision of the national income accounts are going to bring clarity in the national statistics discourse.

The quality of the budget process has emerged as a concern in the recent past. For example, within three months of placement of the national budget for FY2012, it emerged that the subsidy estimates incorporated in the budget has been severely underestimated. Accordingly, on 13 September 2011, the Finance Division prepared a revised estimate of subsidy requirement which revealed that the actual requirement was almost 2.75 times more than the original budget figure.[65] The quality of the budget process has been visibly tarnished because of lack of coordination among different government agencies under the leadership of the Ministry of Finance. For instance, the Ministry of Power, Energy and Mineral Resources did not coordinate with the Finance Ministry regarding the amount of budgetary support necessary for purchasing electricity from (and subsidy arising from selling price of petroleum to) the private (and rental) operators of various sorts. Same was the case with regard to coming at a reliable estimate of fuel import requirement for these power plants. These lapses emerged as a 'Wild Card' as far as fiscal management and BOP situation were concerned. Indeed, the fiasco regarding financing of the Padma Bridge demonstrated that certain line ministries are not inclined to follow the Rules of Business regarding accessing foreign resources. On the other hand, the controversy regarding fixation of transit/transshipment fees for Indian goods transit has publicly exposed the disquieting fact that the MoF has not always been in the driver's seat when it came to economic policy making.

In sum, an inability to demonstrate the right kind of leadership, on the part of the Finance Ministry along with a number of other attendant issues, appear to have contributed towards a slackening of the macroeconomic management during the period under review. This has become particularly a matter of concern as the economy confronts a series of stresses emanating from multiple sources.

Overall State of Macroeconomic Management

The total size of public expenditure is experiencing a significant increase in FY2011-12 due to substantial rise in subsidy and interest payments. Conversely, the expenditures in productive sectors as envisaged under the ADP is not showing any breakthrough in terms of both quantity and quality. The growth in revenue collection is failing to keep pace with the incremental growth of public expenditures. Although the size of the fiscal deficit remains in the safe zone, its financing is emerging as a major concern. The government, in the face low off-take of committed foreign aid, has been resorting to heavy borrowing from the banking sector. The much delayed upward revision of the yield rates of the NSD certificates may lead to some improvement of non-bank financing of the fiscal deficit. However, this will also push

[65]Tk. 47,385 crore as against Tk. 17,261 crore.

up the interest rates in the banking sector. Under the circumstances, there is hardly any alternative to accessing higher level of foreign financing. With financing of Padma Bridge and other mega infrastructure projects remaining in a state of limbo as well as the inability to use highly conditional Indian line of credit, the government has moved to secure a loan from the IMF. The government is also contemplating the costly option of floating Sovereign Bond. One wonders why the government, keeping USD 13 billion in the foreign aid pipeline, finds it opportune to go around for a couple of billions USD? At the same time, one doubts whether the defensive adjustment at the cost of productive expenditure will deliver any result in terms of creation of more gainful employment. A dynamic approach involving enhanced development expenditures underpinned by greater disbursement of foreign aid would have been much more proper approach in this regard.

The defensive adjustment adopted by the government is manifested in the contractionary stance propagated by the central bank in its recently declared Monetary Policy Statement (January-June 2012). While some tightening of money supply was warranted, the current monetary targets of the Bangladesh Bank clearly indicate that it does not plan to discipline the major source of incremental credit demand, i.e. the government. As our earlier analysis shows that instead of restraining credit growth to the government, the new MPS has made space for it beyond the budgetary target. In other words, the burden of cut-back in credit expansion will be exclusively borne by the private sector. As the current inflationary trend in Bangladesh economy is largely a cost-push and structural in nature, high rate of interest is going to impair investment in the private sector with low impact on high price level. As deposit rate in Bangladesh is sticky in nature, it is to be seen whether interest spread increases or not in the coming months. It may very well create opportunity for windfall gains by certain commercial banks. Thus, while the current monetary stance may not be able to effectively rein in the inflationary trend, it may very well affect the economic growth prospect. Thus, there is a need to release the constraint on credit expansion in the private sector by revisiting the repo and reverse repo rates.

The capital market is gradually reverting to its pre-boom level. Regrettably, the market till date has failed to emerge as a broad-based source of long-term equity financing. Given the persisting structural, institutional and regulatory problems in the market, one need to be vigilant about any future attempt to manipulate it to make unscrupulous profit. Recent experience of capital market debacle reemphasis the need for strong coordination between money market and capital market, with a view to ensuring stability in the financial sector.

In the backdrop of sustained pressure on the balance of payment throughout FY2011 and early months of FY2012, some respite has been observed during the recent months (January-February 2012). Notwithstanding erratic growth of exports, low disbursement of foreign aid and stagnation of FDI, the pressure on BOP was partly relaxed due to fall in import growth and steady high flow of remittances. Taka managed to regain a part of its lost value (against major currencies) and foreign exchange reserve partially recovered signaling a possible improvement of overall external balance. As containment of import payments is not an efficient and sustainable way for maintaining external balance, it is important to improve foreign resources flow particularly through further export growth, remittances, and most importantly, foreign aid off-take. It is now to be seen whether the most recent improvements of the BOP is going to consolidate in the coming months.

Investment Scenario: Signs of Deceleration

As mentioned earlier that the current macroeconomic performance including the monetary policy stance would entail investment slowdown leading to economic growth trade-off. A brief review of a number of direct and indirect indicators of investment flow shows such slowdown is gradually setting-in in FY2011-12. Such apparent deceleration comes in the backdrop of stagnating level of private investment as reflected by its share in the GDP for the last five years. For example, private investment-GDP share in FY2010 and FY2011 was 19.4 per cent and 19.5 per cent respectively.

The most direct measure of deceleration of investment is exposed by decreasing trend in industrial term loan disbursement. During the first six months (July- December) of FY2011, the growth of disbursement of term loan was 34.2 per cent – the comparable figure for FY2012 is only 2.3 per cent. In contrast, the recovery rate of disbursement was almost 21.9 per cent during the first half of FY2012. This resulted in a net outflow of resources on account term loan transactions, whereas during the corresponding period in FY2011 there was a net inflow of resources on this account. While the net outflow remains valid for all three categories of industries, namely large, medium and small, it is the large scale industries which has experienced a negative growth in disbursement – (-) 5.7 per cent during July-December 2011).

The downward trend in term loan disbursement to the large-scale industries is paralleled by slower growth rate of import of capital machinery in FY2012. Capital machinery imported during July-December period of FY2012 shows a growth rate of 3.1 per cent over the corresponding period of FY2011. The comparable figure for FY2011 was as high as 28.7 per cent.

Relevant figures relating to opening of letter of credit (L/C) also indicate less than encouraging prospect of future investment. Growth of fresh L/C opening during July-December 2011 was (-) 8.7 per cent for industrial raw material, and (-) 35.0 per cent for capital machinery over the same period of FY2010.

Changes in level of primary energy consumption may be considered as a proxy indicator of investment trend. A stagnating trend in gas consumption may be observed in July-November period of FY2012 in comparison to the preceding comparable period. For example, gas consumption for captive power generation reduced to 1,386 mmcm (July-November 2011) from 1,419 mmcm (July-November 2010). On the other hand, gas consumption in the Industry Sector, marginally increased from 1,375 mmcm in FY2011 (July-November) to 1,396 mmcm in FY2012 (July-November). The state of gas consumption is acting as a deterrent of existing capacities utilisation as well as a constraint on expansion of capacities.

The above cited indicators embody some of the proximate measures of investment in the economy. The only direct measure concerning investment flow relates to FDI and capital market. Review of relevant statistics suggest that net FDI during the first half of FY2012 increased to USD 431 million from USD 342 million, i.e. by 26 per cent. However, the overwhelming part of the incremental inflow was located in the export processing zone (EPZ), where there is little or no gas and electricity supply constraint. The growth of FDI in the domestic tariff area was only 2.6 per cent. Investment through issuance of IPOs in FY2012 remains low – a total of five companies have raised Tk. 588.9 crore as capital which was 58 per cent less than the comparable period of the previous year. Good part of it is, companies involved in the real sector raised more fund in the current fiscal year.

Gas and Electricity Supply: The Binding Constraint

It is well known that limited access to gas and electricity supply has emerged as a binding constraint for investment promotion in Bangladesh. The gas supply in last three years, i.e. between December 2008 to December 2011 has marginally increased from 1,606 mmcf to 1,960 mmcf, indicating an average growth of 7.4 per cent. At the same time, demand for gas increased by 12.3 per cent resulting a yawning demand-supply gap. As result, according to Petrobangla MIS reports, if such a gap was to the tune of 294.5 Mmmf in December 2008, it has swelled to 640 by December 2011. Constricted access to gas supply is obviously holding back new investments. Indeed, after a prolonged period of moratorium on new connections to industrial and commercial establishments as well as to new apartment buildings, the government has only recently started to provide fresh gas connections in a selective and limited way. It is to be seen how the recent developments in the gas sector is going to ameliorate this situation in primary energy sector, i.e. work over of old wells, building new pipelines and discovery of new sources.

During the tenure of the present government a gross total of 3,000 MW electricity has been added to the national grid. Out of this total amount, 874 MW came from the contracts executed during the last Caretaker Government (2007 and 2008) and the rest (2,126 MW) are contracted by the present government. However, due to capacity reduction over the last three years (460 MW) and prevalence of high level of unused capacity (2,539 MW) – due to gas shortage, low gas pressure and shut down for maintenance – the current generation level (as on 06 March 2012) was to the tune of 4,944 MW. This indicates a net increase of only 1,609 MW over the benchmark of 3,335 MW (actual on 6 March 2009). These figures however, do not include the captive capacities which is currently estimated to be around 1,700 MW. Notwithstanding such net addition, the demand-supply gap during the Boro season (FY2012) is estimated to be 2,181 MW as against 1,965 MW three years ago (FY2009). Admittedly, the electricity supply situation would have been catastrophic if the additional capacity did not come on stream, yet it seems that these additional capacity has failed to make a dent on the supply shortfall situation due to a faster growing demand. Thus, to make a perceptible impact on the ground, one will have to reduce the effective supply shortfall. In this connection, it may be mentioned that another 505 MW are expected from a number of projects by June 2012.

The foregoing brief review of the prevailing gas and electricity supply scenario suggests that notwithstanding some positive developments in the sector, the overall situation is still not supportive of new investments, particularly in the industrial sector. Energy scarcity is also affecting agriculture sector, particularly crop production. The realised investment performance in FY2012 will be to a great extent influenced by the unsatisfactory state of affairs in the energy sector.

GDP Growth Prospect

GDP growth target for FY2012 has been set at 7.0 per cent. Incidentally, in all the three years (FY2006, FY2007 and FY2011) when 'six-and-half per cent' GDP growth has been achieved, manufacturing sector contributed about one-fourth of the incremental growth. In these years agriculture sector provide more than one-sixth, while services sector contributed a little less than half of the incremental growth. How is the scenario upholding in this regard in FY2011-12? To seek answer to this question, we may examine the performance of the two main real economic sectors, namely crop production and manufacturing.

During FY2012, production of Aus was robust as it recorded 9 per cent growth. However, as we know, share of Aus in total foodgrains production is quite small, i.e. only 6.2 per cent. On the other hand, Aman accounts for 37 per cent of total foodgrains supply. However, Aman production in FY2012 (12,798 MT) had been almost equal to that of FY2011 (12,791 MT). Under the circumstances, Boro will have attained more than 6.0 per cent growth to ensure adequate contribution of agriculture sector to achieve a six-plus GDP growth. Given the trend growth rate, such a feat will be very unlikely to be achieved.

Industrial output during the first half of the current fiscal year has been impressive, thanks to the buoyant performance of the export-oriented industries. The Quantum Index of Production (QIP) for large and medium industries grew by around 11.5 per cent and small industries – 10.6 per cent. However, review of part trends suggests this level of growth may not be adequate to achieve required manufacturing growth to attain the GDP growth target beyond 6.0 per cent. Given the volatile global situation, it is difficult to confirm with certainty that export-oriented industries will continue to perform at high level. The confidence level further diminishes as we recall the decelerating trend in investment and the unsettling energy situation. Whatsoever, a six-plus GDP growth rate, at the margin, will be seized by incremental growth of the manufacturing along with other sub-sectors of the industrial sector, i.e. construction, electricity and extractive industries (e.g. gas and coal).

The discussion on annual GDP growth rate in FY2012, however, needs to be situated in the context of the medium targets set by the SFYP. The SFYP envisages that the GDP growth rate will increase sequentially from 7.0 per cent in FY2012 to 8.0 per cent by FY2015. In this connection, breaking out of the 6.0 per cent growth trajectory becomes more important than repeating the benchmark. In this connection, catering to the incremental investment requirement through an expansionary fiscal stance becomes imperative. Regrettably, the investment scenario has suffered a setback in FY2012. Annex Table 7.2 reveals that most indicators relating to public finance, monetary policy, capital market and external sector have deteriorated since our last review in November 2011.

Why did this happen, notwithstanding the declared policy objectives of the present government? One may mention two sets of basic reasons in this regard.

First, the current government during the three years refrained from making any serious attempt for structural reforms to address the deficits regarding macroeconomic management and development policy implementation. The reform measures pursued by the current government are mostly initiated by earlier regimes (including the present government in its earlier incarnation). A good example of such incremental reforms may be observed in the operation of NBR. The government did not initiate and deepen any structural reforms including those for building the implementation capacity of the line ministries, for devolution of economic power to the local governments, for streamlining public expenditure portfolio including its productive sectors-related components, and for incrementally accessing traditional and non-traditional resources (both debt and non-debt creating ones). Indeed, a striking example in this regard will be the paralytic state of privatisation of SoEs. During the last three years, not a single of the 22 enlisted enterprises has been privatised as well as no share of any SoEs has been offloaded in the capital market notwithstanding numerous timebound declarations. In the energy sector, indecision regarding use of domestic coal reserve was appalling. The lack of reform of the civil service has hurt the development administration.

The second set of factors which have held back the possible breakthrough of the Bangladesh economy to a higher growth trajectory relates to weak macroeconomic management particularly in the area of resource mobilisation, allocation and utilisation. Indeed, inability to step up resource management at an enhanced level inhibited the economic growth prospect. As a result, the ambitious development programmes remained resource starved, while large volume of committed foreign aid aged in the pipeline. Indeed, we have come to such a stage when the country is failing to hold its regular annual meeting with the development partners. Furthermore, as mentioned earlier, lack of coordination among relevant parts of the government coupled with diminished policy leadership by the Finance Ministry has significantly reduced effectiveness of the macroeconomic management and implementation of economy-wide policies. Lack of structural reforms also greatly diminished the fiscal space for maneuverability by the government.

In this context, it will be interesting to observe how the government designs its penultimate budget of its present tenure (in June 2012). Will it try to consolidate its achievements and promote structural reforms to make a qualitative difference in economic governance for achieving higher level of inclusive growth? Alternatively, in the face of the growing adverse circumstances, will the government resort to a set of populist measures having little significance for strengthening growth fundamentals of the economy? In the coming months it will become apparent whether Bangladesh will be able to transcend into a higher level of economic growth as it has done sequentially in the last two decades.

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ANNEXES

Annex Table 3.1: Projects and their status under the $1 billion line of credit

S/L No.	Project Name	Amount (US$ million)	Endorsed by India (September 2011)	Current Status (February 2012)
1.	Procurement of six dredgers, ancillary crafts and accessories	68.1	Yes	Dropped[a]
2.	Procurement of 10 BG DE locomotives	21.57	Yes	No response from India[c]
3.	Procurement of 50 MG flat wagons and 5 bogie break vans	2.94	Yes	No response from India[c]
4.	Construction of *Khulna-Mongla* Port rail line including feasibility study	175	Yes	No response from India[c]
5.	Procurement of 100 MG tank wagons and 5 bogie break vans for carrying aviation fuel	7.59	Yes	No response from India[c]
6.	Procurement of 10 sets DEMUs	31.16	Yes	No response from India[c]
7.	Procurement of 30 BG DE locomotives	61.67	Yes	No response from India[c]
8.	Procurement of 170 MG flat wagons and 11 MG brake vans	9.61	Yes	No response from India[c]
9.	Procurement of 180 BG tank wagons and 6 bogie break vans	17.61	Yes	No response from India[c]
10.	Construction of 2nd *Bhairab* and 2nd *Titas* bridge with approach rail lines	120	Yes	Consultant recruitment[c]
11.	Procurement of 150 MG coaches	58.27	Yes	Dropped[a]
12.	Procurement of 264 MG coaches and 2 inspection cars	98.72	Yes	Dropped[a]
13.	Procurement of double Decker, single Decker AC and Articulated Buses for BRTC	36.85	Yes	Implemented[c]
14.	Modernisation and strengthening of Bangladesh Standards and Testing Institution (BSTI)	8.97	Yes	Dropped[a]
15.	Establishment of Inland Container River Port at *Ashuganj*	29.64	No	Dropped[b]
16.	Improvement of Lalmonirhat-Burimari landport road million	73.17	No	Dropped[b]
17.	Procurement of 125 BG coaches	35.6	No	Dropped[b]
18.	Upgradation of *Sarail-Brahmanbaria-Sultanpur-Akhaura-Senarbadi* land port	33.3	No	Dropped[b]
19.	Construction of overpass on Jurain railway crossing in Dhaka	7.92	No	Dropped[b]
20.	Development of *Barairhat-Heanko-Ramgarh-Sabrum* land port connecting road	29.31	No	Dropped[b]

Source: Compilation from media sources and interview with ERD officials.

Annex Table 7.1: CPD-IRBD Recommendations (vide 3 November 2011)

State of Implementation of CPD Recommendations	Measures taken by the Government (Date)
General	
The policymakers have to take into cognisance that the economy has entered a difficult period from the perspective of economic management.	Partially recognised by FM. (19 Dec 2011)
Revised Budget	
To operationalise the transitional work programme, the government would need to revisit at the earliest its targets for the current fiscal year relating to public finance. In fact, it should not wait till mid-year to produce the revised budget.	Not acted upon as yet, although ADP revision is underway.
Deficit Financing	
The government has to reign in its financing requirement, particularly by downsizing its subsidy demand.	Administered prices being adjusted.
The government may seek to meet its incremental borrowing need from non-banking sources by increasing the sale of national saving instruments through increasing their yield rates.	NSD rates increased. (Effective from 1 Mar 2012)
As a last resort, the government may have to cut down its development expenditures.	Planning to cut down the ADP by Tk. 5,500 crore. (resource committee meeting on 25 Feb 2012)
Subsidy	
The government is left with no other viable policy choices to adjust fuel and power prices upward in a phased manner. The government may consider bringing up diesel, octane, kerosene and furnace oil prices in line with the prices in India (also to pre-empt smuggling out). However, in order to protect the farmers subsidy on diesel and electricity may be supplied through designated cards.	Fuel prices revised upwards twice since November by Tk. 5 margin each time. (11 Nov 2011 and 30 Dec 2011)
Given the fact that subsidy expenditure has emerged as the core destabilising feature of the economy, greater transparency is required in this area for the citizens to appreciate the problem by providing subsidy expenditure data.	Not acted upon.
Inflation and Safety Net	
Government will have to continue with public procurement of foodgrains, maintain adequate food stock, undertake open market operations when necessary and broaden safety net programmes to keep the food (rice) market stable.	Procurement in line with target. Safety nets and OMS have not been widened but continued in earlier scale.
Monetary policy will have to be coordinated with effective fiscal management if Bangladesh is to reduce the current inflationary pressure.	Not much done. Fiscal management continues to be in doldrums with monetary policy taking the lead.
Issuance of new bank licenses	
Arguably, there is hardly any need for new banks – what the banking sector needs is strengthened oversight relating to compliance of Basel III and possibly improvement of efficiency through competition and scaling up. Bangladesh Bank has drawn up a sound set of eligibility criteria for any new banks. If new licence (s) has/have to be awarded it should not be based on "political consideration", but on rigorous fulfilment of the eligibility criteria. In view of the revealed attempts to relax those criteria, particularly the requirement relating to Tk. 400 crore tax paid sponsors' fund, the Central Bank should remain committed to the criteria that it itself has set. Under all circumstances there should be full disclosure regarding the applications and the award, as and when made.	BB passed recommendations to PMO for 16 new banks from 37 applications. The final number will be decided in March 15 BB board meeting. (9 Mar 2012)
Capital Market	
The demand for implementation of the recommendations of the Probe Committee has now become a far cry.	Not acted upon.
Export	
In view of the EU debt crisis Bangladesh will need to focus on extra-EU markets, particularly markets in the developing countries.	Better performance observed in new markets.
As the export growth rate decelerates, efforts to diversify markets have to be intensified including by taking advantage of the recently announced trade concessions in the Indian market.	Better performance observed in Indian markets.
Exploiting the new RoO in the EU, Bangladesh should also try to diversify its export	Export to the EU increased.

State of Implementation of CPD Recommendations	Measures taken by the Government (Date)
basket.	
Remittance	
In view of the slowdown of remittance growth, the government needs to take additional measures for market development and reduction of transaction cost of migration.	Improvements in new markets (Oman, Mauritius). Existing market in Saudi Arab and Malaysia have also showed revived trend.
Foreign Aid	
The government should put its best foot forward to get the committed foreign funds disbursed for the ongoing projects. Indeed, this will require project by project intensive monitoring jointly with the partners.	No visible progress.
The government may intensify its effort to get budgetary support from the international and regional financial institutions.	No progress with WB. Consultation with IMF underway.
The government may be prompted to go to the global market to secure high cost commercial loan by issuing Sovereign Bonds. Getting loans from foreign private sources to finance fiscal deficits, brought about by high level subsidy off-take, will not be prudent. Indeed, this type of loans, carrying high foreign exchange risk, is not at all acceptable given the growing pressure on the balance of payments.	A committee has been formed to examine the possibility that came up with a policy paper.

Source: CPD. 2012. *State of the Bangladesh Economy in FY2010-11 and Outlook for FY2011-12*. Dhaka: Centre for Policy Dialogue (CPD).
Various newspaper articles.

Annex Table 7.2: Comparative Macroeconomic Scenario: Targets versus Achievements

Components	Actual FY11	Target FY12	IRBD November FY12	IRBD March FY12	Comments
Public Finance					
Revenue earnings					
NBR revenue growth (% growth)	27.2%	15.7%	15.2% (Jul-Sep)	15.9% (Jul-Jan)	**Some improvement; on track**
Non-NBR tax revenue (% growth)	17.8%	18.6%	17.2% (Jul)	9.9% (Jul-Dec)	**Deteriorated; unlikely to attain the target**
Non-Tax revenue growth (% growth)	-1.3%	70.7%	-12.3% (Jul)	64.8% (Jul-Dec)	**Improved; needs further catching up to attain the target.**
Revenue Expenditure (% growth)	18.2%	12.4%	17.6% (Jul)	35.3% (Jul-Dec)	**Deteriorated; likely to exceed target by a large margin**
Pay and Allowances (% growth)	24.0%	8.8%	19.6% (Jul)	12.5% (Jul-Dec)	**Some improvement; further improvement will be required**
Goods and Services (% growth)	17.1%	16.7%	97.1% (Jul)	34.7% (Jul-Dec)	**Improved; but still way exceeding the target**
Interest Payments (% growth)	5.2%	15.5%	21.7% (Jul)	28.5% (Jul-Dec)	**Deteriorated; likely to exceed target**
Domestic (% growth)	5.3%	16.6%	21.7% (Jul)	32.9% (Jul-Dec)	**Deteriorated; likely to exceed target**
Foreign (% growth)	3.8%	3.8%	------	-14.5% (Jul-Dec)	**Will not be a matter of concern**
Subsidies and Current Transfers (% growth)	20.6%	10.2%	7.0% (Jul)	52.3% (Jul-Dec)	**Deteriorated sharply; likely to exceed target**
ADP utilisation overall (% of original allocation)	85.3%	------	11% (Jul-Sep)	34% (Jul-Jan)	**Some improvement; likely to fall short of target**
Corresponding previous FY	85.0%	------	9%	33%	
Taka component (% of original allocation)	100%	------	15% (Jul-Sep)	41% (Jul-Jan)	**Some improvement, will be closer to last year**
Corresponding previous FY	93.0%	------	11%	40%	
PA component (% of original allocation)	63%	------	4% (Jul-Sep)	24% (Jul-Jan)	**Some improvement, but inadequate to attain target**
Corresponding previous FY	74.1%	------	5%	22%	
Overall deficit (excl. grants) (in crore taka)	35014	45204	------	6125 (Jul-Nov)	**Sharp rise in deficit; but likely to remain closer to target**
Corresponding previous FY	25613	35014	------	987.7	
Deficit financing					
Foreign borrowing net (in crore taka)	3267	13058	------	-48 (Jul-Nov)	**Improved than last year; but likely to be below the target**
Corresponding previous FY	6061	10834	------	-394.8	
Domestic borrowing (in crore taka)	29964	27208	------	6061 (Jul-Nov)	**Sharp rise; will be well above the target**
Corresponding previous FY	15318	23680	------	-709.7	
Bank borrowing (in crore taka)	25210	18957	------	15337 (Jul-Nov)	**High growth; will exceed the target by considerable margin**
Corresponding previous FY	-2093	15680	------	3610	
Non-bank borrowing (in crore taka)	4754	8251	------	-9276 (Jul-Nov)	**Deteriorated further compared to last year; will not achieve the target**
Corresponding previous FY	17411	8000	------	-4319	
Monetary Sector					
Broad money supply (M2) (% growth)	21.34%	17.0%	21.64% (Aug)	19.09% (Dec)	**Improved; but further decline is required to attain the target**
Domestic credit (% growth)	27.41%	19.1%	26.63% (Aug)	25.94% (Dec)	**Improved marginally; but still over the target by some margin**
Net credit to Govt. Sector (% growth)	34.89%	31.0%	2.21% (Aug)	73.46% (Dec)	**Deteriorated further; but well over the target**
Net credit to other public sector (% growth)	28.72%		29.68% (Aug)	1.69% (Dec)	**Positive trend; within the target**

Components	Actual FY11	Target FY12	IRBD November FY12	IRBD March FY12	Comments
Net credit to private sector (% growth)	25.84%	16.0%	23.19% (Aug)	19.40% (Dec)	**Declined; however there is a considerable trade off if this fall continues**
Interest rate (%)	12.42%	------	11.76% (Sep)	13.87% (Dec)	**Increasing trend; end year figure will depend on the enforcement of 'self-imposed' cap**
Spread	4.5	5.0	4.3% (Sep)	3.3 (Dec)	**Improved and well within the target!**
Industrial term loan growth (net) (% growth)	3.69%	------	------	Q1: -59.8% Q2: -48.3%	**Not promising**
Agriculture credit disbursement (gross) (% growth)	9.6%	13.3%	-19.0% (Jul-Sep)	-6.2% (Jul-Jan)	**Deteriorated and unlikely to attain the target**
Capital market index	6117 (30 Jun 2011)	------	5036 (31 Oct 2011)	4345 (8 Mar 2012)	**Deteriorated further**
External Sector					
Export (% growth)	41.5%	15.6%	22.6% (Jul-Sep)	13.0% (Jul-Feb)	**Deteriorated; likely to be difficult to attain the target**
Import (% growth)	41.18%	14.0%	16.5% (Jul-Aug)	15.6% (Jul-Jan)	**Improved; but still above the target**
Remittance (% growth)	6.03%	10.0%	12.0% (Jul-Oct)	11.9% (Jul-Feb)	**Growth unchanged; target is well within the reach**
Overseas employment ('000 manpower)	439	------	150 (Jul-Sep)	445 (Jul-Feb)	**Highly positive trend**
Corresponding previous FY	427		89	254	
Total aid inflow (mln USD)	1777.17	------	115.94 (Jul-Aug)	1011.5 (Jul-Jan)	**Somewhat lower compared to last year**
Corresponding previous FY	2164.45		69.12	1084.0	
Net foreign aid	1049.63	------	0.65 (Jul-Aug)	530.5 (Jul-Jan)	**Somewhat lower compared to last year**
Corresponding previous FY	1477.05		-29.48	647.1	
Trade Balance (mln USD)	-7328	-9034	-409 (Jul-Aug)	-4195 (Jul-Dec)	**Deteriorated; likely to remain within the target**
Corresponding previous FY	-5155		-784	-3448	
Current account balance (mln USD)	995	-243	1194 (Jul-Aug)	409 (Jul-Dec)	**Sharp deterioration; likely to remain within the target**
Corresponding previous FY	3724		625	865	
FDI net (mln USD)	768	850	188 (Jul-Aug)	431 (Jul-Dec)	**Improved; likely to be difficult to attain target**
Corresponding previous FY	913		113	342	
BoP overall (mln USD)	-635	-826	89 (Jul-Aug)	-998 (Jul-Dec)	**Sharp deterioration; will be difficult to contain**
Corresponding previous FY	2865		-95	-268	
Electricity Generation (Net) (MW)	4651	------	4803	4944	**Improved; but marginally**
Exchange Rate (Tk/USD)	74.1 (30 Jun 2011)	------	76.2 (31 Oct 2011)	81.7 (07 Mar 2012)	**Deteriorated; but some stability achieved during last one month**
Foreign Exchange Reserve (mln USD)	10912 (30 Jun 2011)	11600	10338 (31 Oct 2011)	9150.0 (7 Mar 2012)	**Declined; not likely to attain target**
Months of import	3.6	------	3.0	3.0	**Remain same; but lower than last year**